ADB

Completion Report

Project Number: 31328
Loan Number: 1974
April 2007

India: Modernizing Government and Fiscal Reform in Kerala Program

Asian Development Bank

CURRENCY EQUIVALENTS

Currency Unit – Indian rupee/s (Re/Rs)

		At Appraisal	At Program Completion
		23 September 2002	20 November 2006
Re1.00	=	$0.0207	$0.0227
$1.00	=	Rs48.22	Rs43.975

UNIT EQUIVALENTS

1 Crore = 10 million

ABBREVIATIONS

ADB	–	Asian Development Bank
EA	–	executing agency
ADTA	–	Advisory technical assistance
FRA	–	Fiscal Responsibility Act
GSDP	–	Gross state domestic product
KARC	–	Kerala Administrative Reforms Committee
KG	–	Government of Kerala
KSEB	–	Kerala State Electricity Board
LSG	–	Local self government
MGP	–	modernizing government program
MGP Department	–	General Administration Modernizing Government Program Department
MOU	–	Memorandum of understanding
MTFF	–	Medium-Term Fiscal Framework
PSP	–	Procurement service provider
SDP	–	Service delivery project
SLPE	–	State-level public enterprise
TA	–	Technical assistance
The Government	–	Government of India
VAT	–	Value-added tax
VRS	–	Voluntary retirement scheme
WMA		Ways and means advances

NOTES

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

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Director General	K. Senga, South Asia Department (SARD)
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[1] The Program Completion Review Mission wishes to express its appreciation to the Modernizing Government Department of Kerala for its assistance in providing information and setting up and facilitating meetings.

CONTENTS

BASIC DATA

A. Loan Identification

1.	Country	India
2.	Loan Number	1974
3.	Program Title	Modernizing Government and Fiscal Reform in Kerala
4.	Borrower	India
5.	Executing Agency	(i) Office of the Chief Secretary and the Finance Department, Government of Kerala (ii) Controller of Aid Accounts and Audit
6.	Amount of Loan	$200 million
7.	Program Completion Report Number	978

B. Loan Data

1.	Appraisal	
	– Date Started	23 September 2002
	– Date Completed	11 October 2002
2.	Loan Negotiations	
	– Date Started	16 November 2002
	– Date Completed	19 November 2002
3.	Date of Board Approval	16 December 2002
4.	Date of Loan Agreement	16 December 2002
5.	Date of Loan Effectiveness	
	– In Loan Agreement	90 days after the date of the Loan Agreement
	– Actual	17 December 2002
	– Number of Extensions	none
6.	Closing Date	
	– In Loan Agreement	31 March 2005
	– Actual	20 September 2005
	– Number of Extensions	One (1)
7.	Terms of Loan	
	– Interest Rate	Determined in accordance with ADB's LIBOR-based lending facility
	– Maturity (number of years)	15.0
	– Grace Period (number of years)	3.0
8.	Disbursements	

a. Dates

Initial Disbursement	Final Disbursement	Time Interval
19 December 2002	17 March 2005	25.0 months

Effective Date	Original Closing Date	Time Interval
17 December 2002	31 March 2005	27.5 months

b. Amount ($ million)

Category or Subloan	Original Allocation	Last Revised Allocation	Amount Canceled	Net Amount Available	Amount Disbursed	Undisbursed Balance
01	200	200	0	200	200	0
Total	**200**	**200**	**0**	**200**	**200**	**0**

C. Program Data

1. Program Cost ($ million)

Cost	Appraisal Estimate	Actual
Foreign Exchange Cost	250	250
Local Currency Cost	0	0
Total	**250**	**250**

2. Financing Plan ($ million)

Cost	Appraisal Estimate	Actual
Implementation Costs		
Borrower-Financed	0	25
ADB-Financed	200	200
Other External Financing: Government of the Netherlands	50	25
Total	250	250

ADB = Asian Development Bank, (Define LIBOR here).

3. Program Schedule

Item	Original Plan	Actual
First Tranche Release	17 December 2002	19 December 2002
Second Tranche Release	30 June 2004	17 March 2005

4. Program Performance Report Ratings

	Ratings	
Implementation Period	**Development Objectives**	**Implementation Progress**
From 16 December 2002 to 31 December 2005	S	S

Note: S denotes satisfactory.

D. Data on Asian Development Bank Missions

Name of Mission[a]	Date	No. of Persons	No. of Person-Days	Specialization of Members[b]
MGP Workshop[1]	22 Mar–4 Apr 2002	1		senior governance specialist
Consultation Mission[2]	12–30 Apr 2002	7		public resource management specialist, principal project engineer, senior governance specialist, social economist, macroeconomist, country director, director
Contact Mission	25 May–1 Jun 2002	1	8	public resource management specialist
Fact-Finding Mission[3]	15–20 Jul 2002	8		public sector management specialist, senior governance specialist, counsel, senior financial specialist, poverty specialist, principal energy specialist, country director, director
Appraisal	23 Sep–11 Oct 2002	4	76	director, public resource management specialist, senior governance specialist, counsel
Country Strategy Program	8–12 Nov 2002	1	5	senior governance specialist
Country Contact Mission	29 Nov–5 Dec 2002	1	7	senior governance specialist
Program Inception Mission	2–17 Apr 2003	2	16	senior governance specialist, principal financial specialist
Procurement Service Provider Pre-Bid Briefing[4]	3–15 June 2003			senior governance specialist
Project Specific-Consultation Mission	13–14 Aug 2003	1	2	principal governance specialist
Procurement Service Provider Inception Mission	27–29 Nov 2003	1	3	principal governance specialist
Review Mission 1	26 May–1 June 2004	2	14	principal financial economist, principal governance specialist
Review Mission 2	1–4 Dec 2004	2	8	principal financial economist, principal governance specialist
Program Completion Review[5]	4-12 July 2006	2	9	economist, assistant project analyst

MGP = modernizing government program.

[1] Together with the Mission for the Public Resource Management Loan.
[2] F. Polman, country director, India Resident Mission (INRM); and K. Gerhaeusser, director, South Asia Governance, Finance and Trade Division (SAGF), joined the Mission at the beginning and end of its visit.
[3] A. Sharma, director, SAGF, provided guidance to the Program Completion Review Mission.
[4] Together with missions to Colombo, Sri Lanka, and Bangalore in Karnataka.
[5] The program completion report was prepared by X. Fan, economist, SAGF.

I. PROGRAM DESCRIPTION

1. The development experience of Kerala, a small state in India, has long been acclaimed for its achievements in human development characterized by a relatively high literacy rate, long life expectancy, and low infant mortality (Appendix 1). However, Kerala's record in economic growth had not been commensurately commendable. For this reason, Kerala's development experience finds an important place in academic discussions and policy prescriptions on development. The classic example is its "lopsided development," which refers to high human development with low economic growth.[1] The policy emphasis of the Government of Kerala (KG) has been on the welfare roles of the government. Its experience has led to the conceptualization of "the Kerala Development Model (the Kerala Model)"— for developing countries that sought to improve social services and the condition of the poor. However, the Kerala Model came under increasing strain over the past decade in the wake of the government's chronic fiscal problems. Worsening fiscal conditions threatened economic growth prospects, resulted in deteriorating social services, and constrained infrastructure investment. By the late 1990s, KG realized it was imperative to carry out fiscal and broad public sector reforms.

2. KG, through the Government of India (the Government), sought the assistance of the Asian Development Bank (ADB) to carry out reforms. The resulting advisory technical assistance (ADTA) 3576-IND: *Supporting Fiscal Reforms in Kerala*[2] effectively served as a project preparatory TA for the subsequent program entitled *IND: Modernizing Government and Fiscal Reforms in Kerala Program*[3] (the Program). KG and ADB agreed to undertake a cluster program consisting of two subprograms for loans totaling $300 million. The design and monitoring framework is in Appendix 2. The first subprogram of $200 million equivalent from ADB's ordinary capital resources was approved on 16 December 2002. The Government of the Netherlands also provided a grant of $50 million equivalent to be disbursed along with the ADB loan through the Government as a cofinancing arrangement.[4]

3. The approval of the Program marked the start of the third public resource management program of ADB at the state level in India, after the Gujarat and Madhya Pradesh programs. The Kerala Program, however, differs from the two previous programs in that it combines two interrelated dimensions: fiscal reform and modernizing government program (MGP). The objectives of the Program were to support the KG to (i) achieve fiscal sustainability; (ii) improve the quality, equity, and value for money of services provided by KG and local self governments (LSGs); (iii) improve the targeting and quality of the poverty reduction programs; and (iv) strengthen the functions and structures of state and local governments. The Program was to be implemented from December 2002 to March 2005. Subprogram 1 was expected to be completed within 24 months. At appraisal, it was envisaged that subprogram 2 would encompass similar components and would continue and expand the initiatives in subprogram 1. Subprogram 2, however, has not been undertaken.[5]

II. EVALUATION OF DESIGN AND IMPLEMENTATION

A. Relevance of Design and Formulation

4. The Program's design and formulation are rated relevant. At the start of the Program, Kerala faced an emerging fiscal crisis. The fiscal deficit rose sharply from 3.4% of the gross state domestic product (GSDP) to 7.3% from 1995/96 to 1999/2000, while the state's debt stock rose from 27.6% to

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1 The economy started moving on a path of growth revival since the late 1980s.

2 ADB. 2000. *Technical Assistance to India for Supporting Fiscal Reforms in Kerala*. Manila (TA 3576-IND, approved on 13 December, for $1 million).

3 ADB. 2002. *Report and Recommendation of the President to the Board of Directors on a Proposed Program Cluster of Loans to India for Modernizing Government and Fiscal Reform in Kerala Program*. Manila (Loan 1974-IND, approved on 16 December, for $200 million).

4 The Government of the Netherlands also approved a technical assistance grant of $6.5 million on 1 October 2003 to support implementation of the modernizing government component of the Program.

5 Section C (program costs) discusses the reasons for this decision.

35.4% of GSDP over the same period. Widening revenue (current) deficits went along with salary increases after implementing the state and national pay revisions in the late 1990s, growing interest payments, and increased pension outlay. This fiscal stress squeezed capital expenditures and greatly diminished KG's capacity to meet its developmental commitments.[6]

5. Kerala was not alone in experiencing fiscal stress in India. Indeed, since the late 1980s, almost all Indian states as well as the central Government have been hampered by persistent and rising fiscal deficits and public debt. These serious problems led the Government to propose fiscal reform initiatives. The measures proposed include a States' Fiscal Reform Facility, which provides grant resources and a broad agenda to assist states to carry out fiscal reforms; and an Accelerated Power Development and Reform Program, which provides concessional financing to states for power sector improvements. KG reached agreements with the Government on fiscal reforms under a letter of shared fiscal goals and objectives dated 4 February 2002, and on power sector reforms reflected in a memorandum of understanding (MOU) dated 20 August 2001.

6. In addition to considering fiscal reforms in line with Government initiatives, KG also embarked on its own administrative reforms. The Third Kerala Administrative Reforms Committee (KARC),[7] set up in May 1997, focused on recommending measures to overhaul the functioning of the Government to make it more responsive and efficient. The KARC report (May 2001) recommended measures aimed at improving service delivery, deepening decentralization, and modernizing government administration. Following the recommendations, KG formulated a MGP[8] and made it a major initiative in the Tenth Five-Year Plan (2002–2007).

7. In light of worsening fiscal conditions across the states as well as the increased importance of state governments due to decentralization, an important dimension of ADB's strategy since the mid-1990s has been to focus on state-level operations. At the request of the central Government, Gujarat and Madhya Pradesh became the first two states to receive ADB assistance for public resource management reforms in 1996 and 1999, respectively, and Kerala became the third in March 2000. KG and ADB initiated policy dialogues from 1997. Initial discussions focused on fiscal reforms. Reflecting the desire of KG, the Program evolved to include both the fiscal and MGP components.

8. While the fiscal reform measures reflected the reform agenda of the central as well as the state governments, the MGP stemmed from KG's own desire for administrative reforms. The ADB Program aimed to support the state's self-inspired MGP and the Government-mediated fiscal reforms. Two design-related factors, however, appear to have weakened the effectiveness and sustainability of the Program. First, there has been little mechanism to effectively integrate the fiscal and MGP dimensions. Second, constrained by the country and state's political considerations, the fiscal and MGP measures did not tackle major causes of fiscal deterioration and service delivery efficiency. These points will be elaborated in the assessment of the Program's performance.

9. ADTA 3576-IND: *Supporting Fiscal Reforms in Kerala* was rated successful by both the TA completion report and the TA performance audit report on fiscal management and tax administration.[9] The ADTA final report has 16 volumes and contains detailed recommendations on improving fiscal management as well as discussions of sector issues such as health services and the MGP. Some

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[6] See Appendix 2 for discussion on fiscal performance in Kerala.

[7] Kerala has had three administrative reforms committees since its formation in 1956. The first committee was constituted in 1957, and the second was set up in 1965. The third committee came into being in May 1997, with the then Chief Minister Shri. E. K. Nayanar as its chairman. The committee members included Shri. K.V. Rabindran Nair, chief secretary, government of Kerala (Retired); Dr. K.K. Subrahmanian, honarary fellow, Centre for Development Studies; Shri. C. J. Joseph, additional secretary, government of Kerala (Retired); and Shri. S. M. Vijayanand, secretary, Local Administration Department, government of Kerala.

[8] See Appendix 4 on modernizing government program.

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

recommendations were implemented under the Program, including introducing the value-added tax (VAT) and enhancing fiscal responsibilities. The effectiveness of the TA, however, was hampered by negative media attention and the mistaken perceptions of a small section of the public. Misconceptions that ADB was forcing its agenda to downsize KG led a small group of protesters to vandalize the project office in April 2002 and forced the consultants to retreat to home offices. This reduced the interaction between the TA team and KG, and impeded the dissemination of the TA output. Further, the TA started with a focus on fiscal management, but was later required to incorporate the MGP agenda. This change in scope about 6 months after consultants were fielded resulted in confusion and may have affected the TA's quality.

B. Program Outputs

1. Fiscal Reforms to Achieve Fiscal Sustainability

a. Rules-Based and Forward-Looking Fiscal Management Framework

10. By far, the most important measure to improve transparency, accountability, and fiscal discipline was the enactment of the Fiscal Responsibility Act (FRA). Based on the MOU between the Government and KG and partly attributable to the timebound conditions of the Program, Kerala was one of the first five states that enacted an FRA and put it into force on 5 December 2003. The FRA envisaged reducing the fiscal deficit to 3% of GSDP and phasing out the revenue deficit by 31 March 2007.[10] The fiscal adjustment targets in the FRA were supported by introducing the Medium-Term Fiscal Framework (MTFF) and tabling the budget estimates in the legislative assembly no later than 31 January every year to ensure the passage of the budget before 31 March of each year.[11] These measures were intended to improve efficiency in resource allocation, predictability of budgeting over the medium term, and the discipline of fiscal management.[12] Another measure was the elimination of the treasury public accounts. The accounts were used as a means of avoiding lapses in budget allocation. Funds transferred to the accounts were considered expenditures. Over time, funds accumulated and became untraceable. The ending of these accounts has improved fiscal prudence.

11. Despite the enactment of the FRA and introduction of the supporting measures, actual fiscal adjustment has not been consistent. Deficit declined initially, but rose again from 2002 to 2004. While the deficits moderated in 2004/05 and 2005/06, they are expected to rise again in 2006/07 (Appendix 3 and Appendix 4). The implementation of the pay revision recommended by the Eighth State Pay Commission in the 2006/07 budget has in particular shaken the adjustment path. As a result, the fiscal and revenue deficits are expected to climb up to 6.0% and 4.3%, respectively, in 2006/07, showing no improvement from the corresponding figures of 5.7% and 4.5% in 2000/01. That the deficits could reach such high levels casts doubt on the state's ability to prune the deficits as laid down in the FRA.

12. The outcome of the Kerala Ceiling on Government Guarantees Act (2003), which became effective on 5 December 2003, is encouraging. The objective of this legislation was to reduce the contingent liability and related risks. Under the Act, the total annual outstanding ceiling on state government guarantees is limited to Rs140 billion. A guarantee fee of 0.75% of the value of the guarantee has been introduced. This has discouraged large corporations from seeking state guarantees. The outstanding guarantee amount declined from Rs13,996 crores as of 1 April 2004 to Rs12,316 crores as of 31 March 2005.[13] The reduction of guarantees has reduced potential fiscal

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[10] The KG has not amended the Fiscal Responsibility Act and Rules to align it with the target date of 31 March 2009 set by Government of India.

[11] While the Budget for 2006–2007 was presented in February 2006, a change in government in May 2006 prompted a revised budget for 2006–2007 in June 2006, in line with standard vote on account procedures.

[12] At the start of the reforms, the aggregate financial discipline of the budget process was weak as evidenced by the tradition of having up to three supplementary budgets in a year.

[13] Kerala Public Expenditure Review Committee. 2006. First Report. (May, p.18).

costs in the event of loan defaults by public sector units. It has also reduced the moral hazard generated by such excess insurance, thus reducing the likelihood of contingent liabilities becoming actual liabilities in the first place.

b. Revenue Mobilization

13. The most important revenue mobilization measure was the introduction of a VAT, which sought to improve the efficiency of and compliance in tax generation. Partly due to the Program, KG was able to introduce the VAT at the earliest date after Government approval on 1 April 2005. Since the introduction of the VAT, KG has made efforts to develop the VAT implementation capacity such as interlinking 15 offices engaged in VAT collection. Still, growth in revenue has been below expectation partly due to the unfamiliarity of traders and tax collectors with the new system. Compliance was also poor as no tax auditing has been undertaken more than 1 year after the VAT was put in place. A comprehensive computerized system has yet to be established for implementing and monitoring the VAT. To compensate for the revenue loss in the transition period, the Government has offered a package[14] to states. Kerala received Rs456 crores in 2005-06 and may need compensation for another year or two. The recent figures have been encouraging. In the first nine month's in FY 2007, VAT collection increased by 48% over the same period in FY2006.

14. Nontax revenues in Kerala are low compared with those of neighboring states. A special committee constituted by KG in 1998 to advise on mobilizing nontax revenues stressed the need for radical improvements in this area. However, little has been done due to a lack of inclination to levy user charges for public services.

15. Overall, the ratio of tax-to-GSDP has not shown significant improvement (Appendix 4). While additional time may be needed for the VAT to feed into improved revenue, continued improvements in the tax and nontax revenue systems are needed to substantially raise state revenue mobilization capacity.

c. Expenditure Restructuring

16. As required by the FRA, KG appointed the Kerala Public Expenditure Review Committee (PERC) in November 2005[15] to monitor the Government's fiscal performance. The state's achievements in expenditure restructuring, however, have been limited despite the appointment of the committee. Statutory payments on salaries, pensions, and interests still take up about 90% of own revenue receipts. The MOU between the Government and KG required KG to maintain a minimum annual net attrition rate of 1% throughout the Program period. Following the civil service reforms, civil service employees declined by 6% in 2002/03. Despite a strong start, KG made the decision in December 2003 to stop further attrition owing to political pressure. The lifting of the ban on recruitment paved the way for recruitment of new staff of 25,000 to replace retiring staff. In 2006, KG accepted recommendations by the Eighth State Pay Commission. This has led to an increase in salary and other benefits amounting to about Rs855 crores annually for 5 years from 2006/07 (Eighth State Pay Commission Report February 2006). The hike in the salary bill has seriously shaken the fiscal adjustment path.

d. Power Sector Reform Prior Actions

17. The Program sought to lay a foundation for power sector reforms by requiring Kerala to initiate prior actions for broad reforms to be supported by a separate ADB-financed power sector program

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[14] According to the compensation package, the Government would compensate shortfalls to the tune of 100% in the first year and progressively down to 75% and 50% in the second and third years, respectively. The shortfall in revenue is assessed based on the average growth rate of the three best growth rates in the last 5 years.

[15] The PERC is an independent committee that is technical in nature. Its members include (i) Dr. Indira Rajaraman, chairperson, senior fellow, National Institute of Public Finance and Policy, New Delhi; (ii). Dr. N.J.Kurian, director, Council for Social Development, New Delhi; and (iii) Shri. K.P. Kannan, National Commission for Enterprises in the Unorganized Sector, Government of India, New Delhi.

loan proposed for 2003. The prior actions included the establishment of the State Electricity Regulatory Commission, the full settlement of dues and liabilities between the Kerala State Electricity Board (KSEB) and KG as of 31 March 2002, approval of anti-theft legislation, and application for the revision of power tariffs before State Electricity Regulatory Commission.

18. KG implemented most of the measures. In particular, loan proceeds were used to settle the liabilities of KSEB. This played a catalytic role in the revival of KSEB. While an ADB power sector program was envisaged, KG decided not to borrow from ADB due to the relatively high interest cost after the loan proceeds were transferred from the central Government to KG. It is encouraging to note that, in the absence of an ADB program, considerable progress has been made toward improving power sector performance. The measures taken by KSEB include strengthening the energy audit, enhancing the Anti-Power Theft Squads, bringing down transmission and distribution losses from around 31% in 2001/02 to 23% in April 2006, reducing the KSEB workforce from 32,000 to 25,000 in 5 years, and the swapping of high-cost debt. Consequently, KSEB reduced the revenue gap from Rs1316.43 crores in 2001/02 to Rs144.58 crores in 2005/06.

19. An improvement in the performance of KSEB goes a long way toward relieving the fiscal burden and enhancing economic efficiency. Many in Kerala attribute KSEB's turnaround to a capable management team, especially the chairman. Due to KSEB's improved performance, however, some important reforms have not been undertaken. For example, tariff rationalization has not been carried out. Instead, KG announced a tariff reduction effective from 1 January 2006 for domestic and commercial consumers. This was implemented despite the strong need of KSEB to upgrade its equipment and technology.[16] KSEB also expects that it will need to increase the number of employees.[17] To sustain the achievements, power sector reforms must be deepened to include institutional changes to improve financial sustainability and economic efficiency.

e. Reform of State-Level Public Enterprises

20. Most of the state-level public enterprises (SLPEs) in Kerala have been incurring losses and imposing heavy fiscal burdens on the state. Under the Program, some positive steps were taken to reduce the backlog on the external audit by carrying out a statutory audit up to 2004–2005 for 22 companies and up to 2003–2004 for 33 companies. This is a useful step before making decisions on enterprise restructuring. Further, 14 SLPEs or nonviable divisions were operationally stopped.[18] No SLPE has been privatized. The emphasis has been on implementing a voluntary retirement scheme (VRS) under the social safety net programs for employees.[19] A total of 3,099 employees accepted the

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[16] For example, the ratio of high transmission to low transmission lines in KSEB is 1:6, compared with 1:1 in more developed systems.

[17] The reason given by KSEB was that as its activities have increased, more employees are needed. However, the consideration to increase employees and implement the tariff cut also signal a continued tendency to implement populist measures, given the nascent nature of improvements.

[18] Closure is defined in various ways: (i) Operational closure. Operations cease and all staff are let go, presumably with VRS. (ii) Financial closure. Assets and liabilities are settled either through the appointment of a liquidator or without this, but the SLPEs financial records are closed and the government treasury actually receives proceeds from the sale of any assets after liabilities have been settled. (iii) Legal closure in accordance with the Companies Act. Legal closure is a lengthy process and is often pending years after operational and financial closure. Most closures in Kerala are operational closure in nature.

[19] The social safety net entailed a financial compensation package and a welfare and economic sustainability package. Under the financial compensation package, all eligible permanent employees are entitled to an amount equal to 1.5 months emoluments for the completed years of service, or compensation equivalent to the remaining months of service left before the normal retirement (whichever is less) plus leave salary, gratuity, notice pay, and so on. Under the welfare and economic sustainability package, a retired employee could invest up to 50% of ex-gratia compensation received in a fund, and receive an incentive of 25% of his or her contribution to the fund from the government up to a maximum of Rs25,000. Deposits are offered with interest at the prevailing nationalized banks rate, which will be used for giving medical and life insurance premiums, and a monthly pension. VRS is the major mode in which the social safety net package has been implemented.

VRS offer. The Program assisted these activities by securing the finance[20] for this purpose. Not only has the VRS had fiscal and economic implications; it also generated positive social impact as these employees had not been paid for a considerable time prior to this.

21. Given the magnitude of the problems, however, the reforms have been marginal. The political ambience in Kerala is highly sensitive to privatization or selling off of public sector units. Kerala has the largest number of SLPEs in India, 113 out of the total 1,071 in the country. Only 90 SLPEs are operational, of which only 38 are making a profit. Accumulated losses reached Rs5,204 crores as of 31 March 2005, compared with Rs1,444 crores a decade ago. Systemic SLPE reforms are needed to make a significant impact on economic efficiency and fiscal conditions.

22. Overall, the achievements of the fiscal reforms under the Program have been patchy. Progress has been made in enacting the FRA, reducing government guarantees, enhancing budget management, introducing the state VAT, improving power sector performance, and undertaking some SLPE reforms. However, few visible benefits have emerged in increasing fiscal space and improving fiscal sustainability. The targets stipulated in the FRA are unlikely to be achieved. A major reason for the lack of improvement in fiscal conditions is that the efforts of fiscal adjustment have not been sustained. Fiscal reforms thus remain far from finished.

2. Modernizing Government Program

23. Kerala distinguishes itself from other Indian states in having a long tradition of and strong emphasis on free provision of many public services to its people. All public service delivery was undertaken by the state government. However, decentralization since the mid-1990s has given the LSGs powers in areas such as health, education, housing, water, and sanitation. As a result, service delivery responsibilities are shared by the state government and LSGs.[21] Against this background, the MGP component sought to improve service delivery, strengthen the functions of the state government and LSGs, and improve the targeting and quality of poverty reduction programs. Supported by the Program and the TA funds from the Government of the Netherlands, 100 MGP initiatives were proposed across 19 departments and over 5 MGP themes (Appendix 5). Among the initiatives, 49 projects in 17 departments are under implementation and study reports have been completed.[22]

a. Improve Public Service Delivery of KG and LSGs

24. The main focus of the MGP was on improving public service delivery (see Appendix 5). Indeed, a defining feature of the MGP component was the implementation of numerous service delivery projects (SDPs). About 10%, or 2,586, of total service delivery institutions in 22 categories (for example district hospitals, high schools, etc.) from eight government departments were selected to conduct the SDPs. The selected institutions prepared plans outlining their infrastructure requirements, need for equipment and other consumables, and other items including training in 2004–2005.

25. Some SDPs support the monitoring and evaluation of the service delivery policy. For example, the Baseline and Citizens Survey was intended to establish baseline data for services offered by institutions under the SDP. Another initiative called *Sevena Mudra* (service mark) was implemented on a pilot basis in 28 SDP institutions to identify performance indicators for both institutions and individuals engaged in service delivery. Other projects target more specific objectives. For example, around 400 information technology access points, called *Akshaya Centers*, have been set up in

[20] The Kerala Industrial Reconstruction Fund was set up in 1999 to assist poorly performing SLPEs. The proceeds from the ADB assistance program were not part of the Fund.
[21] For example, lower primary schools, upper primary schools, and high schools are under the functional responsibility of panchayat; while higher educational institutions are under the state government. A panchayat is a village level LSG. There are about 1,000 panchayats in Kerala.
[22] The list of the 100 initiatives can be found at http://www.keralamgp.org/

Malappuram district to facilitate information exchanges between government and citizens. In the health sector, 110 hospitals have established “hospital kiosks” where birth and death certificates can be issued within 24 hours of reporting.[23]

26. To reduce deterioration of public assets and as required by the Program, KG approved an Asset Renewal Policy in October 2002. An Asset Renewal Fund was established with Rs400 crores, out of which Rs135 crores came from the ADB loan proceeds. Fund utilization has been slow. Rules for the operation of the Fund are still being finalized. The decision of KG to prioritize the use of funds for SDPs has also delayed asset renewal. All the 2,586 institutions under the SDP have an asset renewal component. The possibility of resources being spread too thinly poses challenges.

b. Strengthen the Functions of State Government and LSGs

27. The Program supported a number of measures to strengthen the state and LSGs. One initiative involves the establishment of an integrated personnel and payroll management computerized system in the Secretariat and the commercial taxes department. The system has been established in the Secretariat and will eventually cover all government offices. The implementation of this component constitutes an important step toward attaining e-governance in the state.

28. Measures to enhance the LSG include the merger of the Rural Development Department with the LSG Department in June 2006, which has reduced duplication. Steps have also been taken to strengthen LSGs’ financial management capacity. The redeployment of surplus staff from the state government to LSGs helped relieve staff shortage in LSGs. No less than 20% of the 17,000 identified surplus staff were trained in new skills and redeployed to LSGs.

29. Many functions/institutions of the state government are now transferred to LSGs. However, regular staff of these institutions is still directly paid by, and are under the administrative control of, the state government departments. LSGs can only recruit temporary staff for short periods. Thus, LSG and state departments have dual control over the staff and employees, making their functioning less efficient.

30. By far the most difficult component to implement was the functional review and related restructuring of the Secretariat. The Secretariat is the headquarters of government departments. It plays a key role in policy formulation and advice, laying down rules and procedures, monitoring performance of and coordinating all government departments, the judiciary, and legislature. The third KARC recommended changes to the structures and functions of the Secretariat and associated departments. A committee of secretaries was established in January 2004 to steer the exercise. A small-scale TA (SSTA) project within the Program was provided to assist the review. However, only the design phase of the functional review was completed. The TA consultants faced strong opposition from the staff who perceived that the review would result in retrenchment. To date, the functional review and restructuring of the Secretariat have not been carried out.

c. Improve the Targeting and Quality of Poverty Reduction Programs

31. The Program required the preparation, approval, and notification of an anti-poverty plan; designing a system for poverty monitoring, reporting, and implementing the plan; and a policy for enabling the poor to have access to credit. A poverty monitoring unit was established in the State Planning Board to manage the poverty database. The data collection and validation tasks were

[23] In the case of a child born at home, the parent has to submit an application to the municipality/corporation or the designated authority with details within 21 days. The information is then fed into a computer and a computer-generated certificate is issued to the applicant. It should be noted that most births take place in hospitals in Kerala.

assigned to the *Kudumbasree*.[24] A study on restructuring subsidies for preparing index-based entitlements is under way. The findings will feed into the preparation of the anti-poverty subplan. However, there have been delays in completing the study and validation of the poverty database. The poverty aspects constitute a marginal component of the Program. Since the study is delayed, it is unclear what impact the component will have on poverty targeting and policies in the state.

32. Overall, a defining feature of the MGP component is the implementation of numerous SDPs across nearly 2,600 service delivery institutions. Many good projects have been implemented under this initiative. Some action was also taken to strengthen the LSGs. Despite these, action has been slow in some important areas. This includes the implementation of actual asset renewal and devolution of staffing power to LSGs, while the functional review and restructuring of the Secretariat basically had to be abandoned. Another feature of the MGP is that most of the initiatives are technical and capacity building in nature, while institutional and policy reforms to improve service delivery efficiency are lacking. Reflecting a weakness of the Program design, there was little integration between the MGP and fiscal reform components. As such, the two components can be separated into two programs without any loss. The lack of integration represents a missed opportunity for the Program to make a lasting impact on improving service delivery and fiscal sustainability in Kerala.

C. Program Costs

33. The adjustment costs for carrying out the reforms were estimated at $592 million equivalent over about 4 years. The Program envisaged a cluster of two subprograms totaling $300 million equivalent, with $200 million equivalent allocated to subprogram 1. Subprogram 2 has not yet been carried out. Among the reasons for this is that Kerala is considered "fiscally stressed," which means it cannot borrow from multilateral agencies as per the rules of the Government. The rules were introduced after subprogram 1 was started. There was no agreement among the Government, KG, and ADB on whether a second program is required, and if it is indeed required, what should constitute its thrust.

34. The Government of the Netherlands supported the MGP reforms by contributing $50 million equivalent as a grant to subprogram 1 in addition to the ADB loan. The first tranche of $25 million equivalent was released along with the first tranche of the ADB loan. The Government of the Netherlands did not release the remaining $25 million equivalent, as in 2002, the Indian Government revised its policy and stopped bilateral aid partners from directly supporting state-level policy reforms. The Indian Government replaced the Government of the Netherlands as cofinancier for the $25 million equivalent grant, and released the $25 million equivalent in October 2005. The Government of the Netherlands, however, continued its support of the MGP through $6.5 million equivalent of TA funding, which continued after the completion of the Program and was finished in September 2006. The total loan and grant amount for the first subprogram was $250 million equivalent.

D. Disbursements

35. Subprogram 1 was implemented from December 2002 to March 2005. The first tranche of $100 million equivalent was released on 17 December 2002 along with $25 million equivalent from the Government of the Netherlands. The release of the second tranche of $100 million equivalent was originally targeted for June 2004. However, delays occurred in initiating the MGP TAs, including the setting up of the procurement service provider (PSP). Consequently, the second tranche was released in March 2005.

[24] *Kudumbasree* is an organization which aims at empowering women. It has been introduced by KG to organize women into self-sustaining small units or groups on self-employment activities mainly in the manufacturing and service sectors to help reduce poverty and empower women.

E. Program Schedule

36. The second tranche release was delayed by 7 months, mainly due to the time required to set up the PSP, and also the underestimation of time required by KG during appraisal. The establishment of the PSP, however, significantly enhanced the implementation of the TAs and the Program, as the PSP introduced a flexible and efficient mechanism for consulting services. The 7-month delay should not be considered a major problem.

F. Implementation Arrangements

37. The office of the chief secretary and the Finance Department were the executing agencies (EA). An MGP steering committee was formed in January 2002, chaired by the chief secretary and comprising the principal finance secretary; MGP secretary; principal secretary, General Administration Department; secretary, Planning; and secretaries/principal secretaries of the departments that participated in the Program. The fact that the MGP steering committee included senior public servants was instrumental in facilitating program implementation. There was also a cabinet subcommittee on the MGP chaired by the chief minister, which provided strategic direction on the MGP initiatives.

38. An MGP secretariat, entitled the General Administration MGP Department (MGP Department) was set up in October 2002 to coordinate the MGP component. It coordinated and monitored the activities of the MGP as well as those of the TAs supported by the Government of the Netherlands. Serving as a focal department, the MGP Department significantly strengthened the implementation of the MGP component. The setup of the MGP steering committee and MGP Department provided the institutional foundation that enabled the implementation of a large number of activities.

39. While the setup of the MGP Department facilitated the implementation of the MGP component, this arrangement is transitional in nature. When the Program and the TA fund of the Government of the Netherlands came to an end, staff from the MGP Department returned to their original departments, raising the question about the sustainability of some initiatives. Given that the MGP is a long term and continuous endeavor, reforms need to be mainstreamed into the existing government structure.

G. Conditions and Covenants

40. The first subprogram had 56 conditions. Twenty-four conditions were complied with upon loan effectiveness, and the remaining 32 were required for the release of the second tranche (Appendix 6). When ADB carried out a review mission to evaluate compliance with the second tranche release conditions in February 2005, KG had fully complied with 22 conditions, substantially complied with 8, and partially complied with 2. The ADB Board approved a waiver of full compliance with the two conditions that were partially complied with, and the second tranche was released on 17 March 2005.

41. KG has continued to carry out some policy actions after the completion of the Program. Most of the eight conditions that were substantially complied with have been fully implemented. They include the introduction of the VAT, the establishment of the PERC, the establishment of integrated personnel and payroll management computerized system, the enactment of a Right to Information bill, and the consolidation of the anti-poverty plan of the LSGs. Progress has also been made to establish an Asset Renewal Fund. So far, however, utilization of the fund has been low, as much time has been spent on preparatory work. The decision of KG to prioritize the use of funds for SDP has also delayed asset renewal. Another area of slow progress has been the transfer of staff budgets to the LSGs.

42. One of the two conditions partially complied with during the second tranche release, the functional review of the Secretariat and Commercial Taxes Department, has proven to be by far the most difficult condition for KG to implement, as mentioned earlier. Some progress has been made to

implement the other condition: adoption of the new rules for property tax assessment. KG announced on 16 June 2006 that the new rules would be adopted to determine the property tax. The slow action in property valuation and related revenue generation, however, affected another policy action. KG reduced the rate of conveyance by 4 percentage points in 2004. In line with slow revenue growth related to slow property valuation, the rates have recently been reversed back to their original levels.

43. Covenants that were not conditions for tranche release numbered 38 in the Loan Agreement and 19 in the Program Agreement. These covenants have been mostly fully complied with, or are being complied with. The most important covenant that was not fully complied with was the maintenance of a minimum annual net attrition rate of 1% during the Program period. It appears unnecessary to have so many program-specific covenants, except those dealing with legal relationships of the Program.

44. Overall, it seems that the Program has too many conditions and covenants (113 in total, of which 56 are tranche release conditions) many of which could have been omitted without having a negative impact on the program. Some key conditions, such as the attrition rule, have been left out of the tranche release conditions. Some conditions seem to have been included without proper sequencing. For example, reduction of the rate of conveyance should have been introduced after strengthening the valuation system. The diminishing of revenue following the rate reduction due to slow action on the valuation system has led to the reversal of the rates.

H. Related Technical Assistance

45. Two SSTA projects[25] were approved to support program objectives. The report of TA 3869-IND: *Participative and Pro-poor Fiscal and Administrative Reforms in Kerala* assisted the formulation of service delivery policy and planning. TA 3870-IND: *Strengthening State Government Effectiveness and Accountability in Kerala* aimed at assisting KG to conduct functional reviews in the Secretariat. A preliminary TA report was prepared, but further work had to be cancelled upon agreement between ADB and KG. As mentioned earlier, the staff opposed the functional review as they perceived it as a downsizing exercise. Substantial TA support was provided by the Government of the Netherlands, which approved a TA grant equivalent of $6.5 million on 1 October 2003 to assist in implementing MGP activities. Since early 2004, about 150 TA contracts have been processed using the TA grant.

I. Consultant Recruitment and Procurement

46. Consultant recruitment under the ADB ADTA and the two SSTAs was carried out following ADB procedures and incurred no problems. Recruitment of consulting services funded by the Government of the Netherlands is an outstanding feature of the Program. Instead of defining what TAs will be provided at the outset, a PSP comprising a number of consultants was formed through international competitive bidding by the Netherland Embassy in India to administer the TA funds. The PSP established a database and prepared a procurement manual. The proposals and terms of reference originated from user departments with assistance from the PSP, and were vetted by a committee comprising three members, one each from the MGP Department, the user department, and PSP. In this manner, a large number of diversified TA activities were made possible, reflecting the needs of the user departments. After a slow start, the PSP picked up momentum. Over about 3 years, it processed around 150 TA contracts for 17 departments. The provision of the TA through the PSP ensured state ownership and participation; enabled KG to build capacity in recruiting and managing consultants; and increased efficiency and transparency in awarding contracts.

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[25] ADB. 2002. *Technical Assistance to India for Participative and Pro-Poor Fiscal and Administrative Reforms in Kerala*. Manila (TA 3869-IND, approved on 24 May, for $150,000); and ADB.. 2002. *Technical Assistance to India for Strengthening State Government Effectiveness and Accountability in Kerala*. Manila (TA 3870-IND, approved on 24 May, for $150,000).

47. KG considers the PSP an excellent model for procuring consulting services. However, it is difficult to transfer the PSP model into the government procurement system. The success of PSP hinges on a clearly earmarked and committed fund from an external source to be used with accountability and flexibility. This is generally not the case in government procurement activities. The TAs of the Government of the Netherlands drew to a close in September 2006 and the PSP work has also finished.

J. Performance of Consultants, Contractors, and Suppliers

48. The consultants engaged in the ADB ADTA and two SSTAs were considered satisfactory by the ADB project officer. KG is also satisfied with their performance, despite the fact that SSTA 3870-IND was halted by staff opposition. For TAs managed by the PSP, about 50% were rated excellent, 30% satisfactory, and 20% less than satisfactory among the engaged consultants.

K. Performance of the Borrower and the Executing Agency

49. The performance of the borrower and the EA is rated as satisfactory. KG has shown strong ownership of MGP initiatives, which resulted in support from the highest bureaucratic level. The chief minister also showed a keen interest in the MGP by chairing KARC and a cabinet subcommittee on the MGP. The MGP Department was specifically established to coordinate the implementation of the MGP part of the Program. However, as the Program was completed in December 2005 and the Government of the Netherlands' TAs fund drew to a close in September 2006, the staff from the MGP Department has returned to their original departments. Mainstreaming and deepening the MGP reforms in the existing government structure are essential for the Program to achieve a lasting impact.

50. Compared with its strong enthusiasm toward MGP initiatives, KG's ownership of and commitment to fiscal reforms seem to have been weaker. While there was strong momentum at the beginning of the Program, the efforts faded later on. The implementation of the recent salary increase runs against the continued strong need for fiscal consolidation. Reviving the commitment to fiscal reforms is essential for KG to reduce fiscal stress and achieve fiscal sustainability.

51. Two problems encountered by KG as well as ADB during implementation were negative media coverage and the public perception. At the ADTA stage, the protest and subsequent vandalism by a small activist group of the project office forced the consultants to retreat to home offices. During the implementation of the Program, the functional review met with staff opposition. In addition, generally negative media coverage fed into the mistaken perception that the reforms were imposed by ADB on KG and led to small-scale protests against ADB and KG. This made implementation challenging in a politically vibrant state. KG developed a communications strategy at the beginning of the Program. KG and ADB also correctly identified public discontent as the biggest risk. However, it took some time for KG to effectively implement the communication strategy. KG subsequently stepped up stakeholder consultations both within and outside government. The MGP Department held meetings with journalists, unions, nongovernment organizations, and *panchayats*. A MGP website was constructed. These efforts helped provide information to the media and mitigated opposition.

L. Performance of the Asian Development Bank

52. The performance of ADB is rated satisfactory. ADB's involvement in Kerala reforms dates back to 1997, 5 years prior to the effectiveness of the loan. Through the ADTA and Program formulation process, ADB contributed to the formation of the reforms and established a good partnership with KG. During the implementation from 2002 to 2004, ADB carried out 14 missions.

53. Lessons, however, can be learned from ADB's experience in dealing with the media. When faced with negative media attention and protests from a small group of people, ADB decided that only

Indian Resident Mission (INRM) staff were to address the media regarding the TA and the loan, and consultants were not allowed to respond directly to concerns. The distance from INRM to Kerala meant that INRM was not always able to reduce tensions by immediately addressing misconceptions.

III. EVALUATION OF PERFORMANCE

A. Relevance

54. The Program is rated relevant. It built on the fiscal reform agenda agreed upon by the Government and KG, and KG-inspired MGP initiatives. By providing financial and technical assistance, the Program strengthened the capacity of KG to carry out fiscal reforms and made the reforms more binding. Partly due to the Program, Kerala was one of the first states in India to introduce the VAT and enact the FRA. The power sector benefited from the Program as the settlement of dues and liabilities enabled the sector to start afresh. The Program earmarked and provided resources for restructuring or closing a number of SLPEs. While the MGP only became part of the Program at a later stage, it nonetheless became a more prominent component. Twenty-four of the 32 policy conditions for the second tranche release and 8 of the 13 assurances targeted the MGP. The Program facilitated the implementation of a large number of service delivery initiatives and helped strengthen LSGs. Overall, it provided the resources and impetus for KG to implement reform initiatives.

B. Effectiveness in Achieving Outcome

55. The Program is rated as less effective. In the face of an emerging fiscal crisis, the Program was designed to generate fiscal space and improve fiscal sustainability. Drawing on the agreement between the Government and KG, the Program supported the enactment of the FRA (2003) and the Ceiling on Government Guarantees Act (2003), the introduction of the VAT, the closure of the treasury public accounts, the setting up of an asset renewal fund, initiation of power sector reforms, and some SLPE reforms. However, the introduction of various measures has not been sufficient to achieve sustainable fiscal improvement. In revenue generation, there has been no significant increase in tax to GDP ratio. Consideration of increasing nontax revenue was aborted at the ADTA stage. On the expenditure side, the downsizing of the public sector was lifted 1 year into the Program. Restructuring of the SLPE has been marginal. Lax fiscal discipline was particularly apparent in the implementation of the Eighth State Pay Revision Commission recommendation in the 2006/07 budget. In Kerala, pay revisions are made every 5 years. The increase in salary and other benefits has led to additional revenue expenditure of about Rs850 crores per year from 2006/07 as estimated by the Pay Commission. Revenue and fiscal deficits are expected to shoot up to 4.3% and 6.0%, respectively in 2006/07, virtually no improvement from 4.5% and 5.7% in 2000/01. This fiscal profile is not in keeping with FRA targets.

56. The Program did not tackle the burdens posed by the regular pay revision. An empirical study by Rao[26] (2002) points to a strong correlation between the deterioration of fiscal conditions and pay revisions across India. He noted (pp. 3,266–3,267) that "The principal reason for an increase in expenditures, however, is the pay and pension revision." Even the report of the Eighth Pay Revision Commission pointed out that "the extra financial burden on the Government on account of pay revision is a serious matter that affects the functioning of Government in various ways because of increasing fiscal deficits." The structural rigidities instituted by periodical pay revisions have made fiscal adjustment much more difficult. The continued fiscal stress highlights that merely implementing the Program and enacting the FRA are not sufficient for addressing fiscal problems. Fiscal reforms require long-term and persistent commitments and efforts from KG and the Government, and must be carried out much further beyond the Program.

[26] Rao, M.G. 2002. State Finances in India: Issues and Challenges. *Economic and Political Weekly*, August 3, pp 3,261–71.

57. The focus of the MGP was on improving service delivery, with a wide variety of activities being carried out. Innovative arrangements have been used to implement TAs through the PSP. However, a number of factors are a cause for concern about the effectiveness of the service delivery initiatives. First, despite the implementation of numerous initiatives, there have been few institutional and policy reforms to strengthen the incentives and motivate service providers to improve service delivery. The KG acknowledges that motivating the service providers has been difficult. At least one reason for this has been the lack of a clear incentive mechanism to differentiate performances. Second and related, there have been few measures to improve the accountability of public sector service providers. Often the best way to do so is to empower end users by strengthening competition and giving end users choices. In the health and education sectors, the entry of private sector providers has provided such choices. Indeed, the state has witnessed a large number of users moving from public to private schools and hospitals in recent years. However, effective measures to improve the services of public sector providers remain elusive. Given that low-income families generally rely more on services from public sector providers, enhancing incentives and increasing accountability for these service providers to strive for improvement are important. Third, no effective system to evaluate and monitor service delivery is in place. Social auditing and related activities have been slow in coming and are generally carried out by a very small number of institutions. Furthermore, most of the measures for gaining information that had been experimented with were surveys. Surveys are generally lengthy and resource-intensive exercises that are difficult to carry out frequently and regularly. Nor is it easy to correctly collect, process, and interpret the data. As such, surveys are unlikely to provide sufficient and timely information on service delivery.

58. Although the Program contains fiscal reform and MGP components, few steps have been taken to integrate these two interrelated components. Containing costs has not been a consideration in MGP reforms.[27] Private and public partnership in infrastructure is being discussed, but no concrete progress has been made. Because there were no clear criteria for selecting the MGP initiatives, scarce resources may have gone into initiatives that do not have the highest return—whether economic or social—thereby undermining efficiency. Ultimately, this hurts the poor more, as their options are limited. On the other hand, the fiscal reforms did little to introduce measures to improve service delivery efficiency through budget reforms, expenditure restructuring, and nontax revenue reforms. Further, the success of the MGP will critically depend on KG's ability to create fiscal space. Fiscal reforms to date have not been able to free more resources to finance public service delivery. The increase of expenditure on salaries and other current expenditures crowds out the outlay on capital investment and social services, and undermines the achievement of human development.

59. The fiscal outcome in Kerala and lack of policy reforms on the MGP suggest design weaknesses in the Program (see Section II.A). More importantly, it indicates the difficulty posed by the political economy in the state on fiscal and administrative reforms. A major risk identified at appraisal relates to KG's political will and consensus to pursue reforms. This eventuation of the risk, combined with weaknesses in the design, has reduced the effectiveness of the Program.

C. Efficiency in Achieving Outcome and Outputs

60. The program was implemented efficiently. All but two components of the policy conditions were fully complied with or substantially complied with by the time of the second tranche release. Although the tranche release was delayed by 7 months due to the setting up of the PSP, this initial delay was well compensated for by putting in place an efficient procurement and consulting service mechanism. Overall, the program did not face cost overruns or major delays in the formulation and implementation of policy initiatives.

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[27] In the health sector, for example, one initiative implemented was to strengthen the referral protocol so that patients are not unnecessarily referred to hospitals by doctors. However, doctors still face strong pressure from patients asking to be referred to hospitals, as hospitalization is free. Public hospitals face huge constraints in the supply of doctors, equipment, and medicine partly due to the excess demand induced by free services.

D. Preliminary Assessment of Sustainability

61. The Program is rated as less sustainable. In light of the continued efforts of the Government to improve fiscal health at national and state levels, fiscal measures that have been put in place can be expected to be maintained. The problem, however, is that these measures alone are not sufficient to counter the pressure for increasing current spending. Due to continued weakness in controlling current expenditure and augmenting revenue, Kerala still faces fiscal stress.

62. In the MGP area, as both of the state major political parties are committed to service delivery and decentralization, the work on service delivery and LSG can be expected to continue. However, due to problems discussed in the section on evaluating effectiveness, it does not appear that the MGP has triggered a sustained process toward achieving the broad goals of improving efficiency, reducing costs, and improving service quality and access. While many activities have been carried out by the MGP, most are technical in nature — providing equipment and other consumables, and training. Such actions cannot substitute for policy and institutional reforms that induce attitudinal changes and strengthen incentives for improvement in service delivery. Furthermore, improvement of service delivery can only be possible with sound public finances. Without this critical premise, progress under the MGP will be short-lived. Indeed, persistent fiscal stress continues to undermine the basis for service improvement and a strong government.

E. Impact

63. The Program was categorized as environmental category C and had no direct environmental impact. The MGP components could have some benefits to the poor with the strengthening of the LSGs and carrying out of service delivery activities. Power sector pre-reform action did not have an adverse impact on poverty. In fact, the improved performance has led to the reduction of tariffs and improved services. The SLPEs reforms focused on implementing the VRS and the social safety net and benefited the employees who took the package. This generated some positive social impacts.

IV. OVERALL ASSESSMENT AND RECOMMENDATIONS

A. Overall Assessment[28]

64. The Program is rated partially successful.[29] The Program is relevant in that it reflected ADB's operational strategy, supported Kerala's MGP initiatives, and facilitated the implementation of fiscal measures mediated by the Government. It was carried out efficiently. Implementation was a strong feature of the Program, with all but one condition fully or substantially complied with.

65. However, the Program has been less effective in achieving the objectives of creating fiscal space and enhancing fiscal sustainability. This reflects weakness in the Program design. More importantly, however, despite building up institutions to strengthen fiscal management, there is limited ownership and commitment from KG to carry out fiscal consolidation and maintain fiscal discipline. In relation to the MGP, there were numerous initiatives to improve public service delivery and strengthen the process of decentralization. However, few measures were introduced to facilitate cost recovery, enhance incentives, and improve efficiency of service delivery. There is a risk that the impact could peter out because of a lack of deep-rooted institutional and policy changes.

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[28] The following weights are assigned for the overall assessment: relevance, 20%; effectiveness, 20%; efficiency, 20%; sustainability, 20%; and others, 20%. "Others" include the effort and capacity of KG in (i) implementing the program conditions, (ii) carrying out a large number of service delivery projects, (iii) undertaking numerous initiatives across 17 government departments, and (iv) introducing innovative consulting service approaches through the PSP.

[29] This program completion report (PCR) is part of a sample of PCRs independently reviewed by ADB's Operations Evaluation Department. The review has validated the methodology used and the rating given.

66. While the Program encompassed fiscal reforms and the MGP and is broader than a conventional fiscal management program, that has not really imposed problems in implementation. However, the weakness of coordination and integration between the two components has affected the effectiveness and sustainability of the Program. The deteriorating fiscal outlook will continue to affect the economy of Kerala and the sustainability of the Kerala Development Model. Rising current expenditure will squeeze resources for social expenditure and infrastructure investment. In the absence of fiscal space, any progress on the MGP will be short-lived. At the same time, a persistent service culture that does not consider how best to utilize limited resource adds to the fiscal burden. How to move forward and implement difficult yet necessary reforms is a major task facing KG.

B. Lessons

67. The experience of the Program highlights a number of issues that future ADB programs need to consider. First, the full implementation of a program does not automatically translate into effective and sustainable outcomes. Second, there may be a trade-off between the ease of implementation and achieving the desired outcome. Third, there may be a trade-off between the breadth and depth of reforms in a program. Fourth, for a program to achieve positive and sustainable outcome, governments must possess strong ownership, capacity, and resilience to undertake difficult yet necessary reforms. These questions and other related lessons are discussed below.

68. **Strengthening the Linkage between Outputs and Outcome**. The experience of the Program encapsulates a major conundrum. While the conditions and covenants were largely met, the outcomes do not appear to have been realized. The fundamental problem is that major risks outlined in the design and monitoring framework ended up being major constraints. This in particular relates to lack of political will to make difficult decisions such as disallowing pay increases, limited bureaucratic commitment to and ownership of reforms as evidenced by the reaction to the functional review of the Secretariat, and a service culture without consideration of resource constraints. All these resulted in a weak linkage between outputs and outcomes. A program needs to carefully consider the linkages between the outputs and outcomes, and to mitigate risks that weaken such linkages.

69. **Importance of Government Ownership of and Commitment to Fiscal Reforms.** Related to the point above, fiscal reforms are bound to face political opposition. In Kerala, since stakeholders had limited agreement of the need to balance public finances so as to be able to sustain the MGP, in the end there was limited success on both fronts. Accordingly, a successful ADB program must be underpinned by strong government ownership, commitment, and capacity to weather initial resistance to reforms. ADB needs to actively undertake policy dialogues to secure and sustain government commitment. More importantly, the desire to reform must stem from within the government.

70. **Balancing the Trade-Off between Breadth and Depth of Reforms**. The Program contained 56 conditions and nearly 60 program-specific covenants. However, it overlooked some binding constraints such as pay revision on the fiscal stress. The inclusion of the MGP and fiscal reforms in one program, while posing no major implementation problems, may have diverted attention from the much-needed fiscal reforms. Identifying and tackling the root cause of a problem may bring about more benefits compared with an overly broad program.

71. **Balancing the Trade-Off between Implementation and Building Mechanisms to Bring about Sustainable Changes.** The design of the Program took into account the specific political, cultural, and institutional circumstances of Kerala. This allowed a generally smooth implementation. However, reforms have not been able to reduce fiscal stress, and no major policy and institutional changes have been introduced to improve the efficiency of public service delivery. The Program design needs to carefully consider the trade-off between the ease of implementation and the need to undertake difficult yet necessary changes. While it is important to carefully consider political constraints, it is also necessary to tackle the major impediments to the functioning of an economy.

Effective communication and adequately addressing adjustment costs are also important in "buy-in" public support for difficult reforms.

72. **Complementary Nature of the Program Components**. The Program encompassed fiscal reform and the MGP. Effectiveness and sustainability could have been improved through better integration of the two components. Integration of program components needs to be done at both the design and implementation stages.

73. **Institutional Underpinning of Reforms.** Reforms need to be supported by a strong institutional underpinning. The setting up of the MGP Department served as a platform to coordinate the MGP initiatives. However, the transitional nature of the MGP Department is inconsistent with the need for long-term improvement in modernizing government. It is vital for reforms to be integrated into existing and more permanent government structure so as to sustain momentum.

74. **Importance of Communicating with the Public on Reforms.** Communication and adequate measures to address the concerns of people who are likely to be affected by reforms are necessary to reduce opposition. The experience of the Program highlights the importance of communication and consultation with stakeholders as the initial relatively passive approach did not work in favor of ADB and KG. Program design needs to take the time and resources required for this purpose into consideration. Resident missions need to actively engage in programs, given their geographical proximity to the local government.

C. Recommendations

1. Program-Related

75. **Future Monitoring.** The effective monitoring of program implementation is the primary responsibility of the government. In this sense, strong ownership from the government is vital. In addition, the capacity of the EAs and implementing agencies is also important. Future programs need to consider the ownership of, commitment to, and capacity of the implementing agencies and EAs in monitoring. The effectiveness of ADB monitoring can be enhanced by close cooperation and coordination between operational departments and resident missions.

76. **Further Action or Follow-Up**. Both fiscal reforms and the MGP remain unfinished business. The implementation of subprogram 1 indicates that ADB's participation enhanced local commitment, provided financial and technical assistance, and sped up the reform processes. Whether further reforms will be carried out and whether ADB's involvement is required remain to be seen.

77. The debate on whether subprogram 2 should be carried out is ongoing. KG is currently considered to be financially stressed, and as such cannot borrow from multilateral development agencies based on the rules of the Government of India. However, a subprogram 2 may be possible, given that it was in the Tenth Five-Year Plan of KG, and was committed before the Government issued the rules on fiscally stressed states. KG sees a strong synergy between deepening service delivery reforms and subprogram 2, and has indicated interest in focusing attention on the MGP if subprogram 2 would be undertaken. In its policy dialogue, ADB took the view that it is not desirable to dissociate fiscal reforms from the MGP. Subprogram 2, should it go ahead, should make strengthening public resource management, creating fiscal space, and attaining fiscal sustainability and key objectives. Consideration of the MGP needs to be viewed in this light, as achievement of the MGP will be short-lived without strong public finance.

78. **Timing of the Program Performance Evaluation Report**. The PCR is timely, given that the staff from the MGP Department returned to their own departments soon after the PCR mission. This could mean increased difficulty in obtaining information and some loss of institutional memories of the

Program. On the other hand, it is still too early to evaluate the impact of many service delivery initiatives. It is beneficial for ADB to continue to communicate with KG and share information that can be incorporated in future program designs.

2. General

79. Program costs need to explicitly factor in resources for communicating with people on the need for reforms, and to adequately address the initial adjustment cost to secure public support. A reform program should focus on how to put a system in place so that the incentive structures remain unaffected even after the completion of the program period. Program design and implementation must focus on bringing about sustainable changes.

80. Program loans from ADB generally involve numerous conditions. In the case of the Kerala Program, 32 conditions required compliance within 18 months. Experience from this and other programs shows that focusing on the quantity of conditions does not necessarily ensure sustainable changes are put in place. Furthermore, it is often difficult for governments to implement the conditions, and these can take their attention away from the more important changes that are required. A few conditions targeting the core constraints or major policy bottlenecks and capable of triggering other virtuous changes may deliver a more beneficial impact in the long run. Programs need to focus attention on identifying and addressing major potential underlying barriers to reform. Sound economic analysis and diagnosis, including taking account of political economy and governance factors, are essential to success.

DEVELOPMENT EXPERIENCE OF KERALA – A BRIEF REVIEW

A. Introduction

1. Kerala is a small Indian state with a land area of 38,863 sq. km. and a population of 31.8 million situated in the southwestern part of the country. Generally, its development experience finds an important place in academic discussions and policy prescriptions on development. The classic example is its "lop-sided development," meaning high human development with low economic growth until the late eighties.[1] Its success in achieving high levels of social development and thereby human development has been an outstanding feature and has been highly acclaimed nationally and internationally. This human development progress has been achieved by creating social opportunities in education, health and other areas, though Kerala's record in economic growth has been poor. The policy emphasis of the Government of Kerala (KG) has been on the re-distributive and welfare roles of the government to enhance the capability of the people and to alleviate poverty and inequality. Kerala's experience has even led to the conceptualization of a development model—"the Kerala Development Model"[2]— for developing countries that sought to improve coverage of social services and the condition of the poor.

2. This note presents some highlights of Kerala's social sector development/human development achievements. In so doing, it aims to provide some broad context to enable a better understanding of the role of reforms on Modernizing Government and Fiscal Management in Kerala.

B. Kerala Model and its Limits

2. Kerala has made remarkable progress in providing access to education, health, and other social services for its people without a simultaneous rise in per capita income. Its level of achievement in life expectancy at birth, decline in the infant mortality rate, its level of literacy, and other measures of social development/human development are higher than the all-India average and other Indian states.

3. To illustrate, life expectancy of males at birth in Kerala increased from 44.3 years in 1951–61 to 70.4 years during 1993–97 whereas the corresponding figures for all-India were 35.5 years and 60.4 years. The corresponding figures for females were 45.3 years and 75.9 years in Kerala, and 35.7 years and 61.8 years for all India. The infant mortality rate declined from 120/thousand in 1951–61 to 14/thousand in 1996–2000 in Kerala, whereas the corresponding figures for all-India were 139/thousand and 71/thousand. As for education, the proportion of literate persons in the population of Kerala increased from 81.6/thousand in 1981 to 99.9/thousand in 2001. It is also noteworthy that there has also been a fertility transition in Kerala: the total fertility rate (per woman) declined from 5.6 during 1951–61 to 1.8 during 1996–98 whereas for all-India the corresponding figures were 6.3 and 3.3. The demographic transition in Kerala has lead to age structure change, which in turn has provided windows of opportunity

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[1] The economy started moving on a path of growth revival since the late 1980s.

[2] Although the term "model" was not coined, the study by Center for Development Studies on "*Poverty and Unemployment and Development: A Case Study of Selected Issues with Reference to Kerala,*" can claim to be the first attempt to highlight the remarkable achievement of Kerala in education, health, and other social services through public policies and action despite low economic growth. The study suggested that Kerala offered lessons for other developing countries.

for development[3] as the working age population gradually increased and the dependency ratio declined. Fertility decline combined with public policies enhanced the educational attainment and health of children. Demographic dividends influenced improvement in human development.

4. In short, Kerala has been giving high priority to providing its residents with social opportunities for education, health, and other social services. It has also paid much attention to the delivery of welfare measures, which mainly have been concerned with social security through a public distribution system, a free noon meal scheme for school children, supplementary nutrition to pre-school children and lactating mothers, old age pensions for destitute and rural laborers, a housing security scheme, welfare funds for unorganized workers, and special poverty alleviation schemes. The delivery of all these public services has led to rapid human development. A good summary measure of this high social development is the fact that Kerala ranked first among major Indian states in Human Development Index in 1981, 1991, and 2001.

5. What is striking, however, is the fact that Kerala's success in achieving high human development measures has not been accompanied by high-income growth but by the re-distributive and welfare roles of the state. For almost 30 years, between the late 1950s and the late eighties, Kerala's economic growth was rather dismal. The economy remained more or less stagnant and only showed signs of growth recovery in 1986–87. The decadal annual average growth rates since 1970s as outlined in Table A1.1, give clear evidence of Kerala's slow economic growth until the nineties as the state made much progress in social development. The success of Kerala in social development (human resource development) with low income has led to the conceptualization of its experience as a "model" – the Kerala Development Model.

Table A1.1: Decadal annual growth rates 1993–94 prices: Kerala compared with all-India (%)

Decades	Average Annual Growth Rate of Net State Domestic Product		Average Annual Growth Rate of Per capita Income	
	Kerala	**India**	**Kerala**	**India**
1971–72 to 1980–81	2.34	3.24	0.56	0.93
1981–82 to 1990–91	3.85	5.55	2.47	3.32
1991–92 to 2000–01	6.08	6.02	5.05	3.99

Source: calculation based on data from Central Statistical Organization National Accounts Statistics (various issues)

6. Thus, Kerala has been witnessing "lop-sided development," with high human development alongside low economic growth. Also, a disturbing trend was noticed: with falling levels of investment and new job creation, policy makers did not adjust to the slow growth of the revenue base by restraining the rapid growth of current expenditure. As a result, budget deficits —the revenue deficit and fiscal deficit—widened. The consequent fiscal crisis in the late 1990s necessitated cutbacks in investment and social sector spending, which in turn threatened the sustainability of Kerala's achievements in the social sector (See Appendix 2 for details).

6. The long period of "lop-sided development" in Kerala triggered a series of commentaries in 1990s with a pessimistic prognosis about Kerala's future and the sustainability of the Kerala

[3] For a detailed discussion, see Center for Development Studies (2006) *Human Development Report. 2005. Kerala*, Trivandrum.

model. Some scholars highlighted the fiscal limits to the Kerala Development Model.[4] Others argued that the Kerala economy was on the verge of fiscal crisis due to the heavy burden of the social sector and welfare expenditure in the wake of slow economic growth, and was slipping into a situation of slowing improvement in human development. The particular model of state intervention and mobilized public pressure from the grass roots level which have made social development possible in Kerala, were seen at the very root of the fiscal stress.[5]

7. In general, Kerala's development experience has given rise to the concerns about the long-run sustainability of the Kerala Development Model as low economic growth and severe fiscal stress would constrain the progress in social development and lead to a development crisis—a three fold crisis of (i) prolonging economic stagnation, (ii) continuing inability to generate employment, and (iii) a progressively worsening fiscal situation. In short, the Kerala model was considered naïve romanticism.[6] The following sections look at these three aspects.

C. Signs of Economic Growth

8. Kerala experienced a recovery in growth in the early 1990s. Growth moderated again in the late 1990s and early 2000s, but has strengthened in recent years (Table A1.2). During the first three years of the Tenth Five-Year Plan from 2002 to 2005,[7] Kerala's economy registered an average annual growth rate of 8.6% in the net state domestic product (NSDP) as compared to 6.7% for all-India.[8]

Table A1.2: Annual Average Growth of Net State Domestic Product and its Production Side Components (%)

Industry of Origin	2001–02	2002–03	2003–04	2004–05	2002–03 to 2004–05
Agriculture	-2.5	1.6	1.8	1.7	1.70
PRIMARY TOTAL	**0.1**	**1.4**	**2.8**	**2.5**	**2.23**
Manufacturing	-11.6	-2.2	7.1	5.8	3.57
Electricity, gas, water supply	8.6	4.8	20.9	35.5	20.40
Construction	5.6	19.3	11	-13.1	5.73
SECONDARY TOTAL	**-2.7**	**7.6**	**10.7**	**1.3**	**6.53**
Transport, storage and communication	19.8	3.5	16.6	29.5	16.53
Trade Hotels & Restaurants	-5.6	10.9	6.3	8.4	8.53
Banking & Insurance	14.6	-0.3	7.4	8.5	5.20
Real Estate, business etc	-11.3	15.3	5.4	3.4	8.03
Public administration	-4.8	32.1	2.6	2.1	12.27
Other services	10.1	1.3	3.3	6.7	3.77
TERTIARY TOTAL	**3.1**	**12.2**	**7.7**	**13.8**	**11.23**
NSDP	1.3	9.1	7.4	9.2	8.57
PER CAPITA NSDP (INCOME)	0.4	7.8	6.2	8.0	7.33

NSDP = net state domestic product.
Source: calculation based on data from Department of Economics and Statistics, Kerala

[4] This is the position taken by some scholars though they assumed the complementarity between human development and economic growth. K. K. George, (1993) *Limits to Kerala Model of Development: An Analysis of Fiscal Crisis and its Implication*, Centre for Development Studies, Trivandrum.

[5] Some scholars were even more pessimistic and considered Kerala's social development in perils. See Tharamangalam, (1998) The Perils of Social Development with Economic Growth: The Development Debacle of Kerala, India. *Bulletin of Concerned Asian Scholars.*

[6] See Parayil Govindan, (ed) (2000), *Kerala:The Development Experience*, Zed Books, London.

[7] This is also the initial period of Asian Development Bank's Subprogram 1 on Modernizing Government and Fiscal Reforms in Kerala.

[8] Given the wealth of human resources, it may be argued that Kerala's growth rate should be much higher.

9. Many factors have contributed to the revival of growth after prolonged stagnation, not the least of which is India's economic revival spurred by a shift to market-oriented reforms. In particular, reforms relating to foreign exchange—from fixed exchange to floating exchange, devaluation, and removal of restriction on current account convertibility—has provided incentives for increased migrants' remittances to Kerala. More importantly, there has been a relaxation of controls on private investment on entry and operation into domestic economic activities. Domestic private capital entered into service sectors such as hospitality services, transport services, and tourism. These led to increased investment and output in the service sector. In general, economic reforms along with increased migrants' remittances have contributed significantly to the growth of the service sector and thus to the overall economic growth in Kerala.

10. Indeed, the structure of economic transformation has been dominated by the expansion of the service sector, while growth in agriculture and manufacture has been more moderate (Table A1.2). During the first 3 years of the Tenth Five-Year Plan (2002–03 to 2004–05), the service sector recorded a growth rate of 11.2% as compared to 2.23% for the primary sector (of which agriculture contributed 1.7%) and 6.5% for the secondary sector (of which manufacturing constituted 3.6%). The service sector (tertiary) accounted for 61% of the NSDP in 2004–05 and is the largest contributor to economic growth.

11. In Kerala, the largest part of the service sector is consumer services fuelled by migrant remittances, which equal nearly one third of the gross state domestic product. There is some empirical evidence that economies with large overseas remittances (such as that of the Philippines) have a larger proportion of their total economy made up of the service sector. The sustainability of growth in Kerala thus hinges on the free movement of labor and capital across national borders. In particular, a high level of remittances from the Gulf region has lifted consumption and subsequently the growth of the service sector. It is interesting to note that Kerala, while being an advocate of state intervention, has benefited greatly from market-oriented development in the global economy. Risks in international mobility of labor and capital will affect the Kerala economy. The recent economic growth and transformation of Kerala provides an interesting case to analyze the nature of the growing service sector in Kerala in terms of its orientation to production and consumption, linkages, tradability, employment elasticity, and other related issues.

D. Educated Unemployment, Out-migration, and Remittances

12. Notwithstanding the high human development and recent revival of economic growth, Kerala is still faced with the challenges of increased unemployment. According to the 55th Round of the National Sample Survey, the incidence of the most intense form of unemployment, i.e., chronic unemployment,[9] in Kerala has been four times that of the national average. This marks the contours of the alarming size of unemployment in Kerala. And more importantly, the problem of unemployment of well educated citizens is acute in Kerala, particularly among females. A paradox, however, is that high unemployment coexists with a 'shortage of labor' in sectors such as coconut harvesting, construction, and especially, agriculture. These activities have to rely on migrant workers from other states.[10]

[9] Defined as 183 days or more spent without work in the year preceding the survey period.
[10] See Tharamangalam, (1998) The Perils of Social Development with Economic Growth: The Development Debacle of Kerala, India. *Bulletin of Concerned Asian Scholars.*

13. Growing unemployment has led to increased out-migration of workers to other states within the country and abroad to the Gulf countries in particular. As stated earlier, the phenomenon of migration, especially to the Gulf countries, has had a positive effect on economic growth—at least in raising the consumption level—due to increasing migrants' remittances, which is estimated to be equal to about one third of the gross state domestic product. Interestingly, while Kerala is not among the high per capita income states, it ranks first among the top states in terms of per capita consumption.

14. The increasing flow of migrants' remittances has an obvious impact on raising the demand for quality of public services. A society that heavily depends on out-migration as a solution to growing unemployment and the migrants' remittances as a source for improved standards of living makes heavy demand on education services, especially on quality education to compete in the international market for employment. The point to emphasize is that Kerala society, which depends on the service sector as the major source of growth in the state income, has to sustain the achievement made in its social sector development—human development—and more importantly, has to improve the quality of service delivery in general and in health and education in particular. All this is difficult to attain without ample fiscal space and sound public finance.

E. Prolonged Fiscal Stress

15. Although Kerala's economy has moved to a higher growth trajectory since the early 1990s, coinciding with the shift of the national development policy to market-oriented reforms, its economic performance during the late nineties and early twenties (Ninth Five-Year Plan period) was relatively poor. The real annual average growth rate recorded in NSDP during 1997–98 and 2001–02 was only around 4.2%. The slow growth was, at least partly, a cause as well as the result of the fiscal stress. The gravity of the fiscal crisis manifested itself in the widening revenue and fiscal deficits. This further forced a substantial cut in the Plan size leading directly to a fall in the levels of public investment including the infrastructure and indirectly to the fall in the private sector investment, and cut back in social expenditure.

16. The fiscal stress, which *inter alia* led to a slow down in economic growth in the late 1990s and early 2000 period, was primarily due to sluggish growth in the state government's own revenue and near stagnation in resource transfer from the Central Government. The problem was compounded, as KG could not prioritize and control the "unproductive" revenue expenditure. The then KG, however, recognized the seriousness of the situation and decided to undertake reforms. Underpinned by this recognition, KG entered into an agreement with the Central Government for a package of fiscal reforms, and later entered into an agreement with the Asian Development Bank on a loan for Modernizing Government and Fiscal Reform Programs (see Appendix 2 for detailed discussions).

17. While fiscal reforms have led to implementation of various measures, the achievements on creating fiscal space and improving fiscal sustainability have been very limited. Problems, such as limited revenue generating capacity, pressure for increasing current expenditure, and poor performance of the state level public sector enterprises, still persist, resulting in continued large fiscal and revenue deficits and rising public debt (See Appendix 2 for details). Serious

questions remain about how Kerala can sustain and build on its achievements in human development while it faces persistent fiscal stress.[11]

F. Second-Generation Problems of Social Services

18. Undoubtedly, Kerala has made considerable progress in providing wider access to its people in education, health, and other social sector services, and thus on achieving high human development. However, continued fiscal stress raises questions about the long run sustainability of the development achieved. Furthermore, the state now has to deal with so-called second-generation problems in education, health, and other services. What are the second-generation problems? Having reached a fair degree of success in giving wider access to primary education, primary health in the first phase in a quantitative dimension, questions now arises about how to extend this access to higher levels of education, health, and other services, services that are of high quality and flexible enough to deal with new challenges of time like high quality technical (vocational) education to compete in the labor market and quality health facilities and care to tackle a new genre of diseases. In essence, the second-generation problems are concerned with quality as an essential attribute of capability or development.

19. Already, there are problematic developments in social service sectors such as education and health which are deemed to influence human development. For example, there are emerging concerns about high morbidity and the increasing burden of diseases. Obesity is high in Kerala with 21% as compared to all-India record of only 11%. Kerala society is also faced with increasing mental health and highest suicides rate in India, about three times the country average. In education, there is concern that the quality of service is becoming poor at the post secondary level. Wider access to education services and high human development in the wake of slow growing employment opportunities has also given rise to the problem of increasing unemployment among educated men and women in Kerala on a scale much higher than the all-India average. The challenge for public policy makers is charting a strategy that enables human development through increased quantity and quality of social services based on strong economic growth, increased fiscal space, and enhanced economic efficiency.

G. Perspective for Reforms in Kerala

20. The thumbnail sketch above of the development experience of Kerala highlights a number of interrelated features. First, Kerala has made outstanding progress in providing easy access to social service which contributed to its human development. Second, Kerala faces the second generation problem of providing better and expanded public services. Third, economic growth in Kerala has been dismal for a lengthy period. The recent revival of economic growth must be sustained to create resources for public services and employment opportunities in the face of the persistent high unemployment. Fourth, persistent fiscal imbalances continue to undermine sustainable growth prospects, erode the socio-development gains, and threaten the very existence of the Kerala Model.

21. Kerala's challenge lies in augmenting resources so that it can provide better and expanded public services to its people. It also lies in utilizing limited resource efficiently. Effective measures are needed to strengthen fiscal discipline, create fiscal space, and attain

[11] As pointed out by Tharamangalam (1998), Punjab has overtaken Kerala in per capita expenditures on education and Punjab and Rajasthan in per capita expenditures on health. The Perils of Social Development with Economic Growth: The Development Debacle of Kerala, India, *Bulletin of Concerned Asian Scholars.*

fiscal sustainability. Public service reforms are also required to facilitate pricing of public services to recover the cost. Reform should also explore the feasibility of public-private partnerships in service provision and delivery for increased investment to expand the coverage and improve the quality of services.

22. After accumulating a wealth of human resources, Kerala also faces the challenges of unleashing the potential of its skilled people. The high rate of unemployment of the educated youth rate and associated social problems such as high youth suicide rates call for a more dynamic economy that creates job opportunities. There is ample evidence to show that public investment alone will not suffice to achieve this objective. Creating an environment favorable for private investment is essential for strengthening economic growth and creating jobs.

23. The willingness of Kerala to introduce the necessary reforms is related to the ideology of the political party leading the coalition government at the time. In a politically alert state like Kerala, intensified public communications and resources to deal with the adjustment costs of reform, such as ‘buying in’ public support for reforms, and overcoming the resistance of the entrenched vested interest are essential.

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions* and Risks
Goal Reduce poverty and meet development targets in the Tenth Five-Year State Plan within a sustainable fiscal framework	5-year fiscal targets with the Government achieved Tenth Five-Year Plan midterm review Midterm correction measures Review of antipoverty subplan Service delivery improvement program review	Independent expert group report Midterm review report Revised plan Annual Program Performance Management System (PPMS) reports Annual PPMS reports	
Purpose Support implementation of the Modernizing Government Program (MGP)	MGP implementation plan for subprogram 1 achieved by December 2004 Fiscal targets agreed on with the Government for subprogram 1 achieved in program period PPMS operational MGP steering committee and cabinet subcommittee direct and management performance of Program Midterm review for subprogram 1 completed by end–March 2004 Subprogram 2 designed by October 2004 System of tracking adherence to government orders (GO) issued by the Program in place	MGP reports to cabinet subcommittee Government of Kerala (KG)/Kerala State Electricity Board (KSEB) accounts and budget documents Performance/progress reports to the Government PPMS reports Steering committee and cabinet subcommittee minutes Midterm review report Policy matrix for subprogram 2 MGP secretariat report on status of GO implementation	Stable government and policies remain unchanged KG has the political will and consensus to pursue the Program Stakeholders other than government support the Program and have an effective window to provide advice Unions work in partnership with KG to improve services The central and KG fiscal agreements are sustained for 5 years Enabling measures encourage business to invest in Kerala Resources for capacity building, setting up and upgrading institutions, asset renewal, and maintenance are sustained Fiscal savings are redirected to social expenditure
Outputs: Power Enabling actions for power reform in place	Dues and liabilities between KSEB and KG as of 31 March 2002, settled fully by October 2002 Deficit for KSEB for fiscal year (FY) 2003 partly financed by KG under the budgetary revenue account	KG and KSEB accounts and confirmation letter GOs Revenue account of KG for FY2003 Notification in *Gazette*	Finance Department considers how other states in India have addressed similar issues SERC appointments are transparent and made on the basis of professional criteria Political consensus and consumer acceptance are

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions* and Risks
	State Electricity Regulatory Commission (SERC) established and operationalized by November 2002 KSEB files application for tariff revision before SERC within 2 months of its establishment Tripartite agreement among the central, KG Ministry of Power, and Ministry of Finance in the central government on securitization of outstanding dues to central public sector units signed by October 2002 KG approval for power reform and antitheft reform legislation by October 2002	Letter GOs	achieved
Outputs: Fiscal Medium-term fiscal framework (MTFF) and associated legislation in place	Revised MTFF with summary targets and FY2004 budget published Act on cap guarantees published State Fiscal Responsibility Act published	Budget in brief document and midterm review of MTFF by the central and KG Notification in *Gazette* Notification in *Gazette*	Credible cap established
Revenue enhancement measures in place	Value-added tax (VAT) Act introduced Timebound sales tax arrears reduction targets reviewed by April 2004 No direct tax concessions for sales tax or VAT Reduction in rate of conveyances at least four percentage points, including through the rationalization of the stamp duty system by March 2004 New rules for property tax assessment brought into force by March 2004	Notification in *Gazette* GOs and quarterly collection reports Monthly Auditor General Accounts and Comptroller and Auditor General (C&AG) reports Notification in *Gazette* Notification of rules in *Gazette* and report	The Government's timetable for introduction of VAT does not change Dedicated resources and performance targets are established
Budget preparation, reporting, and	New budget cycle with forward estimates for 2 years	Budget circular, demands for grants and appropriate act	Timetable is followed

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions* and Risks
execution processes reformed	implemented for FY2004 FY2003 accounts tabled in the legislature by 31 October 2003 Midyear budget performance report by December 2003 Timetable for closure of unproductive infrastructure projects approved by KG and published	Accounts presented to legislature Midyear review report by Finance Department Review reports available on the web, plan document, GO on report of State Planning Board (SPB) and plan budget	Expert groups produce credible reviews
Core Functions Service delivery plans in priority areas completed in accordance with service delivery policy	Service delivery policy unit operational by December 2002 Service delivery plans in accordance with service delivery policy being implemented and performance tracked Social audit implementation program in accordance with social audit policy completed Assets renewed in accordance with asset renewal policy	Unit performance reports Service delivery, asset renewal, and social audit policies and plans Service delivery, social audit, and asset renewal reports Copy of audit report, summary reports of Local Self Government (LSG) Department, and Finance Department Project performance reports for service delivery, social audit, and asset renewal Demands for grants and report from Finance Department	Priority services are targeted Genuine improvements in service quality and staff behavior The policies are developed in an integrated manner
Surplus staff redeployed in accordance with policy	Minimum of 20% surplus staff redeployed and posts abolished Computerized personnel (integrated with payroll system) management system established	Quarterly monitoring performance reports by committee accompanied by GOs System reports	KG is committed to maintain the attrition level and contain staff costs within agreed-on targets Policy accommodates staff retraining Transfer of personnel records to system is accurate The system is accessible to all departments/secretariat
Staff transfers on basis of civil service rules	Service guidelines on minimum tenure in post strictly adhered to	Annual administration reports of departments	Politicians are not involved in staff transfers Transfers are undertaken on

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions* and Risks
			the basis of established norms
Functional reviews in priority areas completed	Functional review for secretariat completed and recommendations for restructuring approved Plan to conduct remaining functional reviews approved	Review report/s GO(s) on implementing proposals in review report accompanied by timebound performance targets GO accompanied by plan and performance targets issued	Functional review unit has sound leadership and professional staff Public servants do not see functional reviews as a threat to personal status and positions
Right-to-information legislation enacted and brought into force	Act notified in *Gazette*	Notification in *Gazette*	Sound act that has effective provision for making government machinery more transparent and accountable
LSGs Decentralization of resources and functions from KG to LSGs for subprogram 1 completed	KG-approved LSG action plan for priority activities achieved Transfer of staff completed Plan for transferring salaries District rural development agencies merged with district Panchayats LSG and rural development departments rationalized to ensure clear separation of powers and functions	Quarterly progress and performance report on action plan from SPB to MGFRP steering committee KG report and budget, and LSG budget Notification as per Kerala Panchyat Raj Act and Kerala Municipalities Act Date of dissolution by registrars GO accompanied by plan and performance targets	Political consensus and will not reverse political system of LSGs Ownership by the LSG Department is lacking Systems for staff transfers are sound, with effective monitoring and reporting Sound system for establishing an LSG cadre Unions support the review process
LSGs strengthened	Audit of LSG accounts in accordance with Eleventh Finance Commission Report completed Action plan by LSGs to undertake corrective measures arising from audit Capacity building program in financial management for subprogram 1 completed	C&AG report LSG audit report plans Quarterly progress and performance reports	C&AG has capacity to conduct LSG audits Appropriate sanctions are issued against LSGs that do not follow up C&AG audit report recommendations LSG Department provides effective supervisory function Appropriate sanctions are issued against LSGs that do not participate effectively in the Program Training institutions have capacity to deliver

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions* and Risks
	Capacity building program for phase 2 approved and adequately resourced LSG performance reports published quarterly	GO accompanied by plan, resources, and performance targets LSG Department reports	
Poverty Reduction More effective poverty reduction measures in place	Strategy to enable the poor to access microcredit approved by KG Study on subsidies completed and recommendations approved Antipoverty subplan completed Poverty database, including monitoring and reporting, established Working group on poverty and poverty unit in SPB operational	Strategy document accompanied by proposal for implementation SPB report Subsidy study Plan tabled in the legislature Quarterly coordination reports from poverty monitoring unit	Terms of reference are effective for the study A professional expert group conducts the study The poverty monitoring unit is staffed with professional people A political consensus is reached on the definition of poverty All organizations responsible for providing subsidies agree to use the corporate poverty database
State-level Public Enterprises Action plan for state-level public enterprises restructuring approved Backlog on external audit of at least three statutory public boards reduced by at least 2 years	Voluntary retirement scheme policy and social safety net policy for all regular/permanent, and eligible employees Backlog reduced by 2 years	GO and accompanying plan Annual audit reports by chartered accountants	International and national good practice is accessible High-quality external audit firms are used

* In addition to the assumptions identified in the design and monitoring framework, some assumptions apply to all outputs and need to be addressed by Government of Kerala project staff in developing appropriate risk mitigation measures.

FISCAL PERFORMANCE IN KERALA

A. Introduction

1. Fiscal stress started to affect Kerala in the mid-1980s, and has worsened sharply since the late 1990s. This was manifested in rising revenue and fiscal deficits, and public debt. Intensifying fiscal stress rendered fiscal operations increasingly unsustainable, constrained microeconomic efficiency, and contributed to macroeconomic instability. By the late 1990s, the Government of Kerala (KG) realized that systematic reforms must be undertaken to correct the fiscal imbalance. It subsequently, through the Government of India, sought the assistance of the Asian Development Bank (ADB) to overcome its fiscal problems and improve fiscal performance.

2. This note traces the trends in key fiscal variables before and after the introduction of fiscal reforms after 2000 in Kerala. More specifically, it seeks to assess the overall effect of the ADB Program Loan 1974–IND: *Modernizing Government and Fiscal Reform Program* (henceforth the Program) in Kerala which was implemented from December 2002 to March 2005. By so doing, this note briefly deals with the emergence of fiscal problems in Kerala, reform measures initiated, and the evolving situation. The purpose is to situate the Program in the overall fiscal context and to understand the fiscal development in Kerala.

B. The Broad Context: Fiscal Performance in India

3. When assessing Kerala's fiscal performance, it is important to remember that fiscal imbalances have been experienced by the central government as well as all states since the mid-1980s. India's balance of payments crisis in 1991 was argued to have been precipitated by the high fiscal deficit. The fiscal deficit of the central government had gone up to 7.6% of gross domestic product (GDP) in the second half of 1980s from 5.8% in the first half. The year 1991 was a watershed which ushered in an era of economic reforms comprised of stabilization and structural adjustment policies in India. The stabilization policy sought to improve fiscal conditions at both the central and state levels, while structural reforms infused market principles through the functioning of the economy. State fiscal and revenue deficits emerged in the late eighties, but remained below 1% until the mid-1990s. The situation started worsening in the late 1990s. The deterioration was seen in every individual state, though with variable intensity. Consequently, the need for reforms at the state level emerged in the late 1990s.

4. Various economic and political factors have been attributed to the widespread deterioration in state finances.[1] The economic factors firstly point to sharp increases in wages, salaries, and pensions following pay and pension revisions at the central government and state levels. While fiscal consolidation in the 1990s at the central government level moderately reduced the fiscal imbalance, the implementation of the Fifth Pay Commission recommendations in 1997 entailed a significant increase in the salary bill, which set the stage for a resurgence of fiscal crisis at the central government and, subsequently, state levels. At the state level, regular pay revisions following state level Pay Commission recommendations also represent an in-built inertia which precipitated the fiscal deterioration and magnified the fiscal crunch. Indeed, the emergence of fiscal crisis at the state level could be said to have begun in 1998–99 in the aftermath of the pay hike.

[1] The discussion draws on the analysis of state finances by Rao, Govinda M (2002), "State Finances in India: Issues and Challenges," *Economic and Political Weekly*, August 3, pages 3,261-3,271.

5. Increase in the debt servicing burden exacerbated the fiscal stress. Interest payments increased in the face of accumulating debt stocks and rising interest rates. Until the mid-1990s, interest payments were kept artificially low due to financial repression. With the alignment of interest rates to market rates, interest outlay increased significantly. The average effective interest rate increased from 6% in 1980–81 to 9.2% in 1990–91, and further to 13% in 1997–98 (Anand *et al* 2004).[2] Thus, both the volume of borrowing and the interest rates have increased.

6. At the revenue level, there was an overall failure of the states to pull up their own tax to GDP ratio substantially in tandem with the growth of the economy. The buoyancy of the state taxes fell from greater than 1 to less than 1 in the late 1990s in most states. The principal reason for the low growth of sales taxes lay in states' inability to extend their tax base to the fast growing services sector.[3] The tax bases of states are also narrow because of large-scale exemptions, evasion, and avoidance of taxes. Complicated tax systems, weak administration, and ineffective enforcement mechanisms contributes to poor tax compliance. This not only reduces revenue productivity of the tax system, but also causes serious distortions and inequity. Unlike central government, the states did not undertake systematic tax reforms after the economy was liberalized in 1991. The major reform was the introduction of state level value added tax (VAT) which was only implemented from April 2005.

7. Declining transfers from the centre to states following deceleration in tax devolution further aggravated state-level fiscal stress. As the centre failed to raise the tax to GDP ratio, states' share of central taxes dipped. Net transfers to states, i.e., gross transfers minus repayment of loans, was 33.3% in 1991–92, but dropped to 22.1% in 2002–03.

8. Increases in explicit and implicit subsidies and transfers, and inability to effect adequate cost recoveries in the provision of quasi-public services also contributed to fiscal imbalance. Sharp deterioration in power sector performance and the poor performance of the State Level Public Enterprises (SLPE) in particular contributed to a stagnation or fall in the nontax revenue. After 1975, states showed an inclination towards taking populist measures such as offering electricity to agricultural producers at near-zero tariff levels and selling power to households at prices below cost. Consequently, state governments had to give subventions to State Electricity Boards. Power sector deficits rose up to about 2% of gross state domestic product (GSDP) by the early 2000s. Overall, an inability to generate returns from large investments has been a major reason behind the declining growth of nontax revenues. In most cases, public enterprises do not recover even a fraction of the capital cost and depreciation.

9. On the political side, the report of the 11th Finance Commission pointed to '*competitive populism*' as a major reason for the lax fiscal management. Rao (2002)[4] also concludes that reforms in the latter part of the 1990s were difficult in an era of coalition politics and competitive populism. This competitive populism resulted in central and state governments' reluctance to raise revenue from taxes and user charges, and to increases in expenditures for short-term

[2] Anand, M., Bagchi, A., and Sen, T., 2004, Fiscal Discipline at the State Level: Perverse Incentives and Paths to Reform, in Favaro, E and Lahiri, A., Ed. *Fiscal Policies and Sustainable Growth in India*, Oxford University Press.

[3] Service tax was introduced in India in 1996. Until recently, the Centre was taxing services under the residuary powers and the Finance Commissions were allocating share of service tax to the states. With the 88th Constitutional amendment inserting Article 268, services tax has been put in the Union List and taken out of the divisible pool. Now the service sector is outside the tax net of the states and the revenue collected by the Centre from service tax is not shared with the states.

[4] Rao, Govinda M (2002), "State Finances in India: Issues and Challenges," *Economic and Political Weekly*, August 3, pages 3,261–3,271.

political gains rather than long-term development benefits. Rationalization of employment, salaries, and pensions was extremely difficult for state governments to implement.

10. Overall, by the late 1990s and early 2000s, the inability to contain current expenditure led to large deficits and the build up of debt at the central and state levels. A general response from the states has been to compress development expenditure in social sectors and infrastructure which has been generally related to less adverse political fall out. The expansion of expenditure on salaries, pensions, interest payments, and subsidies crowded out the outlay on the creation and maintenance of physical infrastructure, and expenditure on social services.

11. By the late 1990s, the center as well as many state governments realized that public finance in the country should be subject to systemic rectitude. Five significant policy initiatives broadly determined the contour of fiscal reform at the state level, namely, (i) Tax and nontax measures and, in particular, the implementation of the VAT; (ii) power sector reforms, (iii) general acceptance of the recommendations of the Twelfth Finance Commission (TFC) by the Government of India, (iv) fiscal and institutional reforms through adopting the Medium Term Fiscal Policy Framework at the state level, and (v) governance-related measures.

12. The central government made efforts to encourage states to improve their fiscal conditions. On the basis of the recommendation of the 11th Finance Commission, the Government of India introduced a scheme called “States Fiscal Reforms Facility (2000–01 to 2004–05)” to encourage states to undertake fiscal reforms. The TFC report which forms the basis of fiscal federal relations over the five year period from 2005–06 recommended a higher amount of transfers at 30.5% in the divisible pool of taxes compared to 29.5% as recommended by the 11th Finance Commission. TFC has also infused incentives through enactment of fiscal legislations as a pre-condition for availing debt relief from the Center. Under the scheme, central loans contracted until 31 March 2004 and those outstanding as of 31 March 2005 would get consolidated as loans for a fresh period of 20 years payable in 20 equal annual installments at a reduced interest rate of 7.5% if the Fiscal Responsibility and Budget Management legislation was enacted and implemented. Incentives were also provided for states to follow a trajectory of medium term fiscal correction to phase out revenue deficits by 31 March 2009 and contain the fiscal deficit.

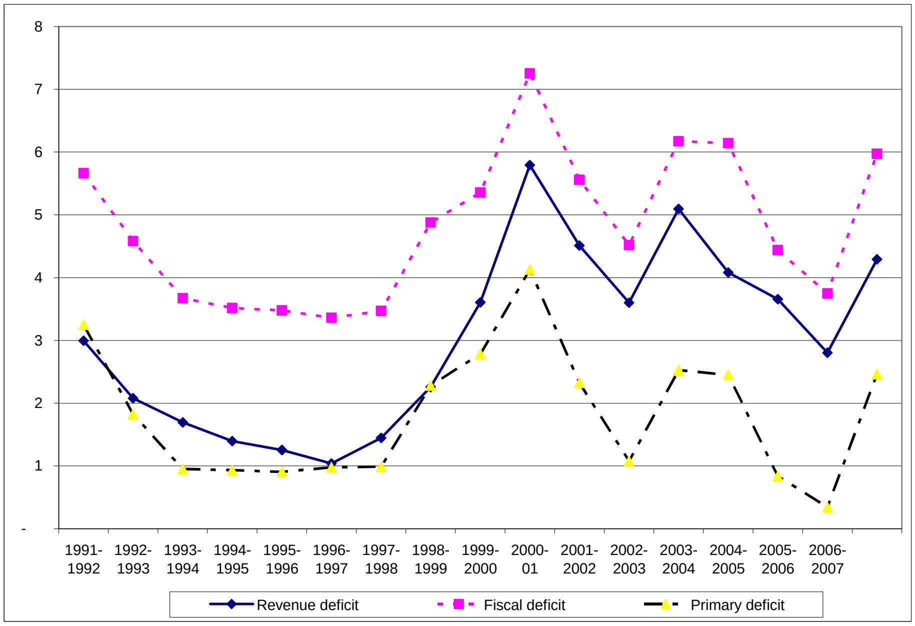
13. The Program was initiated and implemented against the broad context of fiscal stress and the need for reforms at the central government and state levels in India. The following sections focus on fiscal performances in Kerala before and after the Program.

C. Fiscal Imbalances in Kerala Prior to the Program

14. As in other states, fiscal problems of Kerala have been structural. Indeed, all the reasons identified in section 2 of this note apply to Kerala. Moreover, Kerala has had a tradition of large expenditure on social services with very low user fees and cost recovery. This compounded Kerala’s fiscal stress.

15. Revenue expenditure growth far outpaced revenue-receipts from the 1970s to the 1990s. This further translated into increasing deficits. All three conventional deficit indicators of revenue deficit, fiscal deficit, and primary deficits as a share of GSDP reached high levels during the late 1990s (Figure A3). During the first half of the 1990s when GSDP was growing at a fast pace, the ratio of revenue deficits to GSDP fell. However, it increased in the latter half of 1990s as the growth of revenue expenditure outpaced growth of revenue receipts.

Figure A3: Deficit Ratios (% of GSDP)



GSDP = gross state domestic product.
Source: Budget Documents, Government of Kerala, various years.

16. A significant feature of the fiscal operations of the KG had been the rising revenue-deficit as a proportion of fiscal deficit, which was about 80% in 2001/02. An increased revenue deficit indicated the increased requirement for borrowing for current (consumption) expenditure, and the poor quality of borrowing. It also indicated that capital expenditure was compromised. In other words, when the total revenue receipt was not sufficient to meet revenue expenditure, slight revenue was left for capital formation.

17. Worsening fiscal conditions went hand in hand with the state's falling tax buoyancy. All the major components of revenue receipt witnessed a decline as shares of GSDP during the late 1990s. In particular, the buoyancy of own tax revenue (OTR)[5] showed a declining trend. Considering the fact that about 60% of the state's revenue receipt originated from OTR, the declining tax-buoyancy of OTR meant the declining buoyancy of overall revenue. The decline in non-tax revenue receipt, which reflected the state government's hesitancy to recover the cost of public services,[6] and poor return from state investment in, and recovery of, loans from public enterprises contributed to the poor revenue collection from nontax sources.

18. Profligacy in revenue expenditures exerted a significant influence on the state's fiscal health. Revenue expenditure in particular recorded high growth rates in late 1990s reflecting the impact of the Fifth Pay Commission. The component of salary and pension accounted for a substantial portion of revenue-expenditure in Kerala (as in other states) and too frequent

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[5] Average value of Kerala's own tax buoyancy coefficient during 1980-90 was 1.20, but the value in 1991-2002 was 0.89 only. See Rao Govinda M and Chakaborty Pinaki (2006), Multilateral Adjustment Lending to States in India: Hastening Fiscal Corrective or Softening the Budget Constraint, *Journal of International Trade & Economic Development*, Vol.15, No.3, pages 335-357.

[6] The extent of subsidies given to the social and economic service was huge (see Srivastva D.K., et.al (2003) *Budgetary Subsidies in India: Subsidising Social and Economic Services*, National Institute of Public Finance and Policy, New Delhi.

upward revision of this component (unlike in most other states) tended to widen the fiscal imbalance.

19. The fall in the growth of central government transfers also contributed substantially to the fiscal imbalance of the state. The shift in criteria for inter-state distribution of share-able taxes was particularly disadvantageous for Kerala. The criteria developed by the Ninth Finance Commission were primarily to mitigate horizontal imbalances among the states. This put Kerala in a disadvantageous position as it had already attained a high level of human development as a result of its earlier policies and programs. The devolution of central tax revenue to Kerala as a proportion of the state's total tax revenue and the general purpose grants under article 275 declined sharply after the Ninth Finance Commission award, and reduced to zero in the later years.

20. While all Indian states faced fiscal imbalances by the late 1990s, Kerala's state finances were in a more precarious state, as shown in Table A3.1 which presents a comparison of selected fiscal indicators among the southern Indian states.

Table A3.1: Fiscal Indicators: A Comparison among the Southern States in 2001–02

Fiscal Indicators	Andhra Pradesh	Karnataka	Kerala	Tamil Nadu	Average
Own revenue/revenue exp	62.6	58.8	**55.5**	67.6	61.1
Tax revenue/ revenue exp	50.8	53.0	**50.8**	60.4	53.8
Non-tax revenue/revenue exp	11.8	5.9	**4.7**	7.2	7.4
Interest payment/revenue exp	18.5	14.4	**21.3**	16.3	17.6
Social sector exp /total exp.	35.0	34.8	**37.6**	37.1	36.1
Revenue deficit /fiscal deficit	42.9	56.0	**79.7**	57.8	59.1
Capital outlay/FD	46.0	35.9	**17.1**	37.5	34.1
Non-development exp/aggregate disbursements	30.3	28.8	**43.3**	36.7	34.8

FD =Fiscal deficit.
Source: Reserve Bank of India State Finances: A Study of Budget 2003-04

21. The ratios of own revenue receipt to revenue expenditure, tax revenue-to-revenue expenditure, and nontax revenue to revenue expenditure were lowest in Kerala, implying it had the highest level of imbalance in relation to revenue-expenditure and the consequent revenue-deficit. The obvious inference is that there is a high degree of dependence of the state on market borrowing and loans from the central government to meet current expenditure. Kerala also has the highest ratio of revenue deficit to fiscal deficit, which indicates poor quality in its borrowing. Kerala's combination of the highest revenue-deficit ratio coupled with the lowest ratio of capital-outlay to fiscal deficit indicates the crowding out of capital formation. The highest ratio of interest payments to revenue expenditure sends a note of caution about the increasing burden of debt accumulation and its servicing obligation, especially when the debt is not contributing commensurately to capital formation. Indeed, in line with low revenue receipts and high revenue expenditure growth, capital expenditure as a share GSDP declined from an average 3.59% for the first half to an average 2.64% in the second half of the 1990s.

22. Thus, while fiscal imbalances and deficit indicators are seen in all Indian states in the 1990s, the severity of these conditions has been relatively high in Kerala. The fiscal deficit was nearly over 4% on average during the 1990s and reached around 7.25% by 1999–2000. The high level of current expenditure commitments on account of the high salary bill, interest payments and other statutory payments in the face of falling and fluctuating revenue receipts dragged the state into a severe liquidity crisis and threatened its fiscal credibility. To overcome

the problem of cash-crunch, the state resorted to ways and means advances (WMA) and over-draft facilities from the Reserve Bank. The state also resorted to heavy withdrawal from the public account, especially the state's provident fund, and allowed accumulation of arrears of payments to contractors. These features were nothing but signs of a fiscal crisis in Kerala in the early twenties. As the fiscal stress was eroding the credibility of the government to fulfill its functions, it became imperative to restore fiscal balances.

D. Kerala's Fiscal Reforms since 2002

23. As stated earlier, fiscal stress with different degrees of intensity has been a characteristic of all states since the mid-1990s. Different states responded with different fiscal reforms. A few states have opted to avail themselves of the structural adjustment lending facilities and fiscal reform programs set up by multilateral agencies to complement their own reform efforts. Kerala is one of three states (the others being Gujarat and Madhya Pradesh) which availed of the assistance of ADB. In December 2002, the ADB approved the Program. A key objective of the Program was to generate fiscal space through reform initiatives that complement the state and central government mediated reform efforts.

24. Details of the fiscal reform program have been discussed in the main project completion report. However, it is useful to restate the major reform initiatives and the extent of state government's compliance. In this context, particular mention should be made of the State Government's Fiscal Responsibility Act (FRA). Supported by the Program, the FRA was brought into force on 5 December 2003. The FRA initially envisaged reducing the fiscal deficit to 3% of GSDP and phasing out the revenue deficit by 31 March 2007. The KG also approved and implemented the Kerala Ceiling on Government Guarantee Act (2003) by virtue of which an upper ceiling (Rs140 billion) to the state government guarantee was prescribed. Rules for the creation of a guarantee redemption fund were prepared with the provision of the collection of a fee at a rate of 0.75% of the value of guarantee. Yet another rule-based reform initiative relates to the Medium-Term Fiscal Framework (MTFF), which provided for 3-year forward estimates along with annual budgets. The aim was to chart a fiscal consolidation adjustment path for state finances. The MTFF acted as a crucial link between the annual budget formulation process and the fiscal objectives enshrined in FRA, which required the government to report to the legislative assembly the medium-term fiscal policy statement inter-alia laying down a 3-year rolling target for fiscal indicators.

25. Based on the requirement of the Program and consistent with the policy reform recommendations of the central government, KG enacted and implemented a state VAT to replace the state sales tax. Other revenue measures supported by the Program related to the amendment to the tax rates that had been creating distortions as in the case of stamp duty and the rate of conveyance. The KG reduced the rate initially but soon restored it to the original level due to a fall in revenue collection and the delay in the estimation of "fair" or market value of property.

26. The reform measure that received much emphasis initially was expenditure-rationalization, which aimed to prioritize productive expenditures. Under the Program, the KG was to maintain a minimum annual net attrition rate of 1% throughout the Program period. In effect, however, the government could not comply with this condition. The KG was also required to pursue civil service reforms. However, the political pressure of the trade union was so strong that the Government lifted the ban on recruitment of replacement staff in December 2003. Similarly, the pressure from unions forced the government to put in cold storage the

implementation of functional reviews in the Secretariat, which was considered as an important step towards eventual reallocation of staff and savings on current revenue expenditures.

27. Given the nature of the aforesaid fiscal reforms of the Program and the manner in which these were implemented, a policy relevant question emerges: did the Program help the state to solve the immediate fiscal stress problem of the time and to improve its fiscal performance through hastening fiscal consolidation? A rough and ready method of answering the question is a comparative assessment of the behavior of key fiscal indicators during the period before and after the implementation of the program in the state.

E. Behavior of Fiscal Indicators since Implementing the Program

28. A comparative picture of the trends in the growth of revenue receipts, revenue-expenditure, capital outlay, and accumulated debt and its servicing burden before and after the Program is presented in Table A3.2.

Table A3.2: Basic Fiscal Indicators (% of GSDP)

Items	2000–01	2001–2002	2002–2003	2003–2004	2004–2005	2005–2006	2006–2007 (BE)
Revenue Receipts	**12.51**	**12.52**	**13.16**	**13.10**	**13.46**	**13.70**	**15.17**
State Own Tax Revenue	8.41	8.19	9.03	8.97	8.93	8.76	9.25
Nontax (Own)	0.94	0.75	0.84	0.89	0.82	0.84	0.88
Resource from Center (Central Govt. Transfers)	3.16	3.58	3.28	3.24	3.71	4.10	5.05
Share in Central Taxes	2.27	2.23	2.12	2.23	2.40	2.26	2.40
Other Central Transfers (Grant in Aid)	0.88	1.35	1.16	1.01	1.31	1.85	2.65
Revenue Expenditure	**17.02**	**16.12**	**18.25**	**17.18**	**17.11**	**16.50**	**19.47**
Salaries + Pension + Interest	12.44	11.79	12.26	11.98	11.52	10.97	13.11
of which, Salaries	6.44	5.81	5.79	5.62	5.33	5.03	6.39
of which, Pensions (including superannuation allowance etc.)	2.77	2.54	2.82	2.67	2.59	2.56	3.21
of which, Interest	3.24	3.44	3.65	3.69	3.60	3.39	3.51
Capital Receipts	**5.90**	**4.82**	**5.91**	**6.11**	**4.66**	**3.93**	**5.96**
Capital Expenditure	**1.22**	**0.99**	**1.17**	**2.14**	**0.88**	**0.99**	**1.75**
Total Debt Stock	**34.28**	**37.25**	**38.42**	**41.53**	**41.74**	**41.14**	**43.30**
Revenue Deficit	4.51	3.60	5.09	4.08	3.66	2.80	4.29
Gross Fiscal Deficit	5.56	4.52	6.17	6.14	4.44	3.75	5.97
Primary Fiscal Deficit	2.32	1.08	2.53	2.45	0.84	0.34	2.46

GSDP = gross state domestic product.
BE = Best estimate
Source: Controller & Auditor General - Finance Accounts of Kerala for 2005-2006. October, 2006; and Budget of Government of Kerala, various issues

29. Data reveals that there have been signs of progress in fiscal consolidation from the introduction of Program. However, the pace of progress does not seem to be sustained, as a tendency of slippage appeared later. The deficit indicators reduced from 2002–03 to 2005/06, however, deficits increased significantly in 2006–07 (best estimates). Fiscal development can be further examined by looking at the revenue, expenditure, and deficit indicators in detail.

1. Revenue Receipts

30. The total revenue receipts of the state is composed of the state's own tax and nontax receipts and the transfer of shareable-taxes and devolution of grant by the central government

on the basis of the recommendations of Finance Commissions. The lion's share of state revenue receipts is from own tax revenue, which constitutes about 60% of the total revenue receipts. In line with the Program conditionality, the sales tax has been replaced with state VAT based on stage-by-stage tax credit system and harmonized rates since April 2005. Under the VAT the highest rate is only 12.5% whereas average rate of 17–18% was prevalent under the sales tax. However, lower tax rates have not led to improved compliance. As a result, there has been no significant increase in the growth rate of tax revenue compared to the pre-Program period. The receipts from own non-tax revenue only constitutes about 7% of total revenue receipts as the state government has shied away from charging reasonable user-fees.

31. Overall, the growth of total revenue receipts after the implementation of the Program improved over the earlier period. However, the increase was moderate. Kerala, which was leading other states during the 1980s in tax-GDP ratio is now third after Tamil Nadu and Karnataka.[7] The most important factor in this lackluster revenue growth is the fact that the service sector, which is the largest contributing and fastest growing sector of GSDP,[8] is outside the tax-net of the state. Furthermore, there is widespread evasion of tax[9] as acknowledged in the revised Kerala Budget 2006–07. Given the current level and growth rate of revenue expenditure, the potential for enhancing the revenue receipts of the state to substantially reduce the deficit ratios, especially the revenue-deficit, as envisaged in the Kerala FRA and MTFF will be limited unless (i) there is a reorganization in the taxing powers of the states vis-à-vis the central government or in the divisible pool of central government taxes to give the states the tax-benefits of the fast growing service sector, and (ii) serious efforts are made on the part of the state to regulate tax evasion and provide incentives for tax compliance.

2. Revenue Expenditure

32. It is evident from Table A3.2 that there has been a decline in the rate of growth of revenue expenditure leading to lower revenue expenditure to GSDP ratio before 2002/03. However, revenue expenditure increased afterwards, and the revised budget estimate of 2006–07 anticipates a sharp increase. The emphasis of the Program on containing revenue expenditure has been a correct strategy and successful in achieving the desired result in the initial period, until this trend was eroded when the state government began to reverse its reform initiatives like the ban on recruitment of replaced staff, reducing the attrition rate, and prioritizing development expenditures.

33. The major portion of the state's revenue expenditure is spent on Salaries (S), Pensions (P), and Interest payment (I) SPI. Growth of the aggregate SPI has slowed down with the progress in the Program. Expenditure on salaries as a proportion of revenue receipts came down from 51.4% in 2000–01 to 30.4% in 2004–05. However, it is expected to go up due to the impact of the implementation of the 8th State Pay Revision Commission's recommendations. The announcements of the pay increase in Kerala took place in February 2006, just before the election date was announced.[10] The fiscal burden of the Pension is also likely to go up by virtue

[7] For a discussion of comparative tax buoyancies of Indian states, see Indira Rajaraman et.al (2006), "Tax Buoyancy Estimates for Indian States", *Economic and Political Weekly*, April 22, pages 1,570–1,573.

[8] For detailed analysis see Subrahmanian K K (2006) "Economic Growth in the Regime of Reforms: Kerala's Experience," Economic and Political Weekly, March 11–17, pages 885–890.

[9] To give an example, the total turnover of gold in Kerala is around Rs10,000 crores and at 1% rate the tax collection during 2005–06 was Rs21 crores, whereas it should have been Rs100 crores. Obviously, tax evasion is significant and has reduced the effective rate of taxation to 0.21%.

[10] The election to the assembly was held in April 2006 and a new government [a Communist Party of India (Marxist) led coalition] was formed in May 2006.

of the recommendation of the 8th Pay Revision Commission and more importantly, due to the early retirement age (55 years) and high longevity of life (life expectancy is 73.5 years) in Kerala. The problem is compounded by the fact that Kerala has not moved to a contributory provident fund system instead of pension payments. The rise in pay and other benefits has been implemented by the KG despite concerns about its fiscal implications.

3. Deficit Targeting and Quality of Debt

34. The FRA laid down timebound targets for elimination of revenue deficits and containing fiscal deficits as a fixed proportion of GSDP. The Medium Term Fiscal Policy & Strategy Statement and the Medium Term Fiscal Plan for Kerala 2005–06 to 2006–07 had aimed to reduce the fiscal deficit as a proportion of GSDP from 4.75% in 2000–01 to 1.40% in 2004–05. The deficits were moderated after the implementation of the Program. The revenue deficit as a proportion of GSDP declined from 5.09% in 2002–03 to 2.80% in 2005-06. The Fiscal Deficit relative to GSDP also showed a trend of decline and moved from 6.17% in 2002–03 to 3.75% in 2004–05. However, deficits are expected to rise significantly in 2006/07 due to the implementation of the 8th State Pay Revision Commission's recommendations.

35. Due to the persistent deficit, the debt to GSDP ratio is expected to rise from 38.42% in 2002–03 to 43.30% in 2006–07. The rise in debt is due to the fact that fresh additions to loans were substantial and a major portion of it went into repayments of old loans. The prevalence of the revenue deficit meant that the state had to resort to borrowing to meet part of the revenue-expenditure. The state had to cut planned outlays as a good part of its permissible borrowing had to be used up for meeting the current revenue expenditure. The revenue-deficit accounted for a large part of the fiscal deficit, indicating poor quality borrowing and hence the debt. With the implementation of the Program, the ratio of revenue deficit to fiscal deficit declined from 83% in 2002–03 to 75% in 2005–06, implying an improvement in the quality of debt. Yet it is disturbing to note from an inter-state comparison (see Table A3.3 below) that today Kerala has the highest state ratio of revenue deficit to fiscal deficit.

36. In line with the low revenue receipts and high revenue expenditure growth, capital outlay as a proportion GSDP was only 0.90% in 2004–05, substantially lower than the 3.11% average in the 1990s. Reforms have certainly fallen short of freeing up more resources for capital expenditure.

Table A3.3: Proportion (%) of Revenue Deficit in Fiscal Deficit: Inter-State Comparison

State	2001–02	2002–03	2003–04	2004–05
Kerala	**79.7**	**82.5**	**66.4**	**82.4**
Tamilnadu	57.8	71.9	28.0	30.9
Karnataka	56.0	50.1	11.7	12.1
Andhra Pradesh	42.9	40.1	39.8	21.8
Mahashtra	75.1	65.6	46.3	49.8
Gujarat	103.4	58.6	40.5	41.7
Punjab	76.3	85.3	73.0.	60.4
Orissa	71.4	56.0	39.8	68.7
Madhya Pradesh	86.8	28.8	61.1	-21.9
Uttar Pradesh	62.5	53.9	111.6	52.4
Rajasthan	66.0	64.5	46.5	37.0
West Bengal	75.0	81.7	71.1	75.4

Source: Reserve Bank of India Bulletin (Supplementary), April 2006.

37. Overall, the implementation of reform measures supported by the Program helped to contain the growth of revenue expenditure and thereby reduced revenue and fiscal deficits. However, fiscal consolidation has fallen short of the magnitude stipulated in the FRA and MTFF. Efforts such as a ban on staff recruitment, functional review, and restructuring of staff expenditure were reversed or stopped owing to political considerations.

38. Prima-facie, the improvement in fiscal conditions is reflected in the decline in the dependence of the state on WMA from the Reserve Bank. The state was in overdraft for 200 days in 2000–01 and the number of days this was the case fell to 47 in 2005–06. There has also been improvement in fiscal indicators. However, the success of fiscal reforms could not be sustained for long in Kerala. This was because the gains in revenue augmentation were only moderate, which, in combination with the state government's backtracking on expenditure rationalization measures, led to slippages in the overall fiscal performance targets and reversed the achievements made under the Program.

39. The state had committed to fiscal consolidation in line with its fiscal sustainability strategy enshrined under FRA 2003 by reducing the fiscal deficit to 3%, and eliminating the revenue deficit by the FY2007. The revised and budgeted fiscal deficit figures mentioned in the medium term fiscal policy statement presented by the new government are anticipated to be of a higher order. The prospect of revenue-deficit elimination and substantial reduction of fiscal deficit within a short period would not be bright unless there is a firm commitment on the part of the government to contain increasing nonproductive expenditure.

F. Concluding Observations

40. The fiscal health of Kerala had been deteriorating sharply since the late 1990s and reached an acute stage just after 2000. The state's finances slipped into a crisis situation putting the Government's fiscal credibility at stake, with fiscal imbalances and deficits due to revenue-expenditure growth far higher than that of the revenue-receipts, large contingent liabilities curtailing efficient resource-allocation, inefficient governance at micro-levels (e.g. delivery of public services), and difficulties in macroeconomic stabilization. The Government was forced by the then fiscal conditions to introduce central government mediated fiscal reforms and also a program loan from ADB to help the state hasten fiscal consolidation.

41. The fiscal conditions of the state showed improvement during the years of reform implementation, although the pace slowed down later when the state government reversed some of the reform initiatives. The political environment played a significant role in the outcome of the Program and Fiscal Reforms. An earlier study[11] of inter-state comparisons of the outcome of structural adjustment loans and fiscal consolidation reached a similar conclusion. The wavering political environment in the state played a major role in the moderate progress of fiscal reforms.

42. Thus viewed, the immediate future does not appear bright for sustaining the initial benefits derived from the Program and other fiscal reforms. Some fiscal reforms introduced earlier has gradually been reversed. In the current financial year 2006–07, the fiscal health has already started showing signs of deterioration, as evidenced from the fact the Government has taken recourse to WMA and overdraft facilities from the Reserve Bank.

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[11] See Rao, Govinda M, and Chakraborty Pinaki (2006) Multinational Adjustment Lending to States in India: Hastening Fiscal Corrective or Softening the Budget Constraint?, *Journal of International Trade and Economic Development,* Vol.15, No.3 pages 335–357.

43. The Kerala experience suggests the fiscal reforms under the support of Program is a bitter, but necessary, pill to swallow for a sub-national government to correct the deterioration of its fiscal health. Its success, however, will depend upon the willingness of Government to tolerate the “bitterness” of the medicine in terms of its short-term disadvantages and opposition from vested interest-groups for the sake of seeking fiscal correction to ensure the state’s macroeconomic stability, economic development, and inter-generational equity.

BASIC FISCAL DATA (% OF GSDP UNLESS OTHERWISE SPECIFIED)

	1990-1991	1991-1992	1992-1993	1993-1994	1994-1995	1995-1996	1996-1997	1997-1998	1998-1999	1999-2000	2000-01	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006	2006-2007 (BE)
Revenue Receipts	**17.04**	**16.27**	**16.65**	**14.74**	**14.64**	**13.99**	**13.82**	**14.40**	**12.80**	**12.71**	**12.51**	**12.52**	**13.16**	**13.10**	**13.46**	**13.70**	**15.17**
State Own Tax Revenue	9.51	9.55	9.46	8.81	8.78	8.73	8.77	9.10	8.27	8.31	8.41	8.19	9.03	8.97	8.93	8.76	9.25
Nontax (Own)	1.48	1.34	1.40	1.21	1.24	1.38	1.16	1.13	1.00	0.85	0.94	0.75	0.84	0.89	0.82	0.84	0.88
Resource from Center (Central Govt. Trans	6.06	5.38	5.78	4.71	4.61	3.88	3.90	4.17	3.54	3.55	3.16	3.58	3.28	3.24	3.71	4.10	5.05
Share in Central Taxes	3.45	3.29	3.45	2.82	2.63	2.68	2.79	2.57	2.46	2.46	2.27	2.23	2.12	2.23	2.40	2.26	2.40
Other Central Transfers (Grant in Aid)	2.61	2.09	2.33	1.89	1.98	1.21	1.10	1.60	1.08	1.09	0.88	1.35	1.16	1.01	1.31	1.85	2.65
Revenue Expenditure	**20.04**	**18.35**	**18.34**	**16.14**	**15.89**	**15.03**	**15.27**	**16.65**	**16.41**	**18.50**	**17.02**	**16.12**	**18.25**	**17.18**	**17.11**	**16.50**	**19.47**
Salaries + Pension + Interest			11.62	11.14	11.17	9.99	10.06	10.11	10.41	13.22	12.44	11.79	12.26	11.98	11.52	10.97	13.11
of which, Salaries			7.04	6.81	6.82	5.75	5.89	5.66	5.79	7.20	6.44	5.81	5.79	5.62	5.33	5.03	6.39
of which, Pensions (including superannuation allowance etc.)	2.08	1.93	1.87	1.75	1.77	1.85	1.70	1.85	2.05	2.89	2.77	2.54	2.82	2.67	2.59	2.56	3.21
of which, Interest	2.42	2.76	2.72	2.58	2.57	2.38	2.48	2.60	2.57	3.12	3.24	3.44	3.65	3.69	3.60	3.39	3.51
Subsidies				0.33	0.33	0.32	0.41	0.37	0.41	0.46							
Capital Receipts	**6.73**	**6.16**	**5.69**	**4.95**	**5.31**	**4.03**	**4.09**	**4.88**	**5.42**	**7.90**	**5.90**	**4.82**	**5.91**	**6.11**	**4.66**	**3.93**	**5.96**
Public Debt (internal borrowing + Centre)	12.51	13.89	13.50	6.54	3.95	2.79	2.62	3.06	7.06	9.49	10.69	11.93	14.49	6.02	4.57	3.88	5.88
Nondebt Capital Receipt (recovery of loans & advances)	0.13	0.13	0.10	0.13	0.08	0.08	0.14	0.07	0.12	0.08	0.17	0.08	0.10	0.08	0.09	0.05	0.07
Public Account	24.30	23.32	23.66	23.95	25.14	29.27	26.83	34.30	30.38	34.96	30.32	26.35	31.67	29.52	34.16	37.34	30.38
Public Debt (Net)	3.42	2.81	3.09	1.63	3.00	2.37	1.93	2.01	2.66	2.50	3.00	2.71	3.21	5.29	4.02	3.58	4.50
Public Account (Net)	2.31	1.51	1.37	1.57	0.40	0.96	1.51	3.13	2.43	4.59	2.81	2.04	2.61	0.74	0.54	0.30	1.38
Capital Expenditure	**3.91**	**4.50**	**3.54**	**3.18**	**2.80**	**2.83**	**2.60**	**3.19**	**2.46**	**2.13**	**1.22**	**0.99**	**1.17**	**2.14**	**0.88**	**0.99**	**1.75**
Public Debt (Discharge of Internal debt + repayments of loans to Centre)	9.10	11.07	10.41	4.91	0.95	0.42	0.68	1.06	4.40	6.98	7.69	9.22	11.28	11.45	11.85	0.53	4.79
Loans & Advances by State	0.98	1.00	0.69	0.88	0.90	0.95	0.77	1.19	0.71	0.51	0.39	0.22	0.31	1.43	0.20	0.26	0.62
Public Account	21.99	21.81	22.29	22.38	24.74	28.31	25.32	31.17	27.95	30.37	27.59	24.31	29.05	23.72	33.61	37.04	29.55
Capital Outlay	1.82	1.63	1.39	1.37	1.40	1.45	1.40	1.49	1.16	1.04	0.83	0.77	0.86	0.71	0.68	0.73	1.12
Total Debt Stock	**33.46**	**31.18**	**33.51**	**28.54**	**29.11**	**27.65**	**27.69**	**29.24**	**30.37**	**35.39**	**34.28**	**37.25**	**38.42**	**41.53**	**41.74**	**41.14**	**43.30**
Total Receipts (Revenue Receipts + Non-debt Capital Receipts)	**17.17**	**16.40**	**16.75**	**14.87**	**14.72**	**14.07**	**13.97**	**14.47**	**12.92**	**12.79**	**12.68**	**12.59**	**13.25**	**13.18**	**13.55**	**13.75**	**15.25**
Total Expenditure (Revenue Expenditure + Capital Outlay, excluding Net Lending)	**21.85**	**19.98**	**19.73**	**17.50**	**17.29**	**16.48**	**16.67**	**18.15**	**17.56**	**19.54**	**17.85**	**16.89**	**19.12**	**17.89**	**17.79**	**17.24**	**20.59**
Deficit indicators (negative amounts)																	
(1). Revenue Deficit	2.99	2.08	1.69	1.40	1.25	1.04	1.45	2.26	3.60	5.79	4.51	3.60	5.09	4.08	3.66	2.80	4.29
(2). Gross Fiscal Deficit	5.66	4.58	3.67	3.52	3.48	3.36	3.47	4.88	5.36	7.25	5.56	4.52	6.17	6.14	4.44	3.75	5.97
(3) Primary Fiscal Deficit	3.25	1.83	0.95	0.93	0.91	0.98	0.99	2.28	2.78	4.13	2.32	1.08	2.53	2.45	0.84	0.34	2.46

BE=best estimate, e, – = missing data.

Sources: Government of Kerala, Finance Accounts of Kerala for 2005-2006, Published by Controller & Auditor General, October, 2006. State Finances–A Study of Budgets, Reserve Bank of India

MODERNIZING GOVERNMENT PROGRAM IN KERALA

A. Background and Evolution

1. Kerala was under chronic and acute fiscal stress in the late 1990s. The fiscal imbalance was so serious that the Government of Kerala (KG) found it necessary to substantially slash the size of planned investment and drastically cut expenditure on education, health, and other social services. This affected Kerala's achievements in human development and threatened the very existence of the Kerala Development Model. In fact, the fiscal stress led to a crisis situation as the government faced popular resentment when its treasury failed to meet payment obligations on time. The then KG felt the need for introducing fiscal reforms and also to seek subnational structural adjustment loans from international development agencies for establishing fiscal stability.

2. In line with the realization of the desirability of reforms with external support, the then KG started preliminary discussions with the Asian Development Bank (ADB) in early 1998 for a program on public resource management with emphasis on fiscal reforms. It submitted a concept paper to the Government of India in October 1998 requesting ADB's support for changes in public finance, state-level public enterprises, power sector, and decentralized planning. In May 2001, there was a change of government, but the engagement with ADB continued.

3. Between 1998 and 2002, 11 missions from ADB visited Kerala to assess progress in introducing reforms. Initial discussion between the ADB and KG focused on fiscal reforms. However, reflecting the long tradition of government involvement in human development and public services delivery, as well as the recommendations of the Third Kerala Administrative Reforms Committee Report (May 2001), KG considered that administrative systems and service delivery mechanisms must be toned up to make the fiscal reforms effective. This view found some support within ADB as well. Consequently, a broad program entitled Modernizing Government Program (MGP) was formulated combining two components: modernizing government and fiscal reforms. In other words, the fiscal reform program expanded to also include an MGP midway in the processing of the program. The change was related to the evolving thinking of KG as well as the changing view and composition of the ADB missions. Although the MGP component only became a part of the Program at a later stage, it nonetheless became a more prominent component. Under subprogram 1, 24 of the 32 policy measures, and 8 out of 13 assurances related to the MGP. The objectives of the MGP were to overhaul governance towards achieving greater efficiency and effectiveness, particularly in service delivery.

4. The ADB approved a cluster loan concept comprising subprograms 1 and 2, and sanctioned Loan 1974-IND for $200 million from its ordinary capital resources under subprogram 1—*Modernizing Government and Fiscal Reform Program in Kerala* (the Program)—in December 2002 along with a grant of $25 million from the Government of Netherlands (GON) to support the reform agenda under fiscal reforms and the MGP. In addition to the program, the GON also provided KG with a technical assistance (TA) grant equivalent to $6.5 million. While ADB subprogram 1 was implemented from December 2002 to March 2005, the technical assistance funded by the GON grant has just been completed in September 2006.

B. Major Themes

5. MGP is structured around five themes, namely: (i) ensuring assured levels of basic services to the poor; (ii) building an enabling environment for growth; (iii) efficient, effective, and

accessible local self-government (LSG); (iv) enhancing the effectiveness and efficiency of core government functions; and (v) fiscal sustainability.

6. Under these five themes, 100 initiatives across 19 government departments were identified based on discussions and communications between policymakers, experts, heads of local governments, and civil society groups. Detailed implementation plans listing activities and costs were prepared for every initiative. These initiatives were mainstreamed into the state's development budget. Currently, 49 projects under the general initiatives are being implemented in 17 departments.

7. As MGP evolved, KG considered that in addition to the general initiatives, a core program needed to be developed to reflect policy priorities, public need, and development impact. Taking their cue from the development experience of the state, KG decided to launch the service delivery project (SDP). About 10% of all the service delivery institutions, or 2,587 institutions, in 22 categories, from eight government departments such as health, education, and revenue have been chosen to carry out these projects. Thus, although MGP was designed as a multi-dimensional agenda, its major focus was on improving service delivery.

C. Major Service Delivery Initiatives

8. Kerala distinguishes itself from other Indian states in having a long tradition and strong emphasis on free provision of many public services by the government to its people. Public service delivery was all undertaken by the state government. However, decentralization since the mid-1990s has given the LSGs powers in the areas such as health, education, housing, water, and sanitation. As a result, service delivery responsibilities are shared by the state government and LSGs. In the education sector, for example, lower primary schools, upper primary schools, and high schools are under the functional responsibility of *panchayat*; while higher educational institutions are with the state government. In health area, primary health centers are with gram *panchayats* and district hospitals with the district *panchayat*, while state general hospitals and medical college hospitals are with the state government. In water supply, Kerala Water Authority of the state is responsible for pipe water supply, while *Panchayat* (LSG) can tap other sources (tanks, ponds, river lets, etc.) within their geographical territory and responsible for water supply to the respective geographical areas.

11. A service delivery policy was developed by KG in March 2004 to guide the service delivery projects, the policy vowed to overhaul government systems and institutions to enhance the efficiency and effectiveness of service delivery and to make it people-centered and equitable. The policy is applicable to both the state and local governments. It is to be incorporated into the development planning process so that Service Delivery Plans become part of the State Development Budget. At the state government level, implementation of the policy started in the revenue and registration departments. At the LSG level, the policy was first implemented in the primary health care centers of 14 village *panchayats*, 3 municipalities, and 1 corporation.

12. SDPs have been an outstanding feature of the MGP. These projects sought to improve the delivery of public services at the grass roots front line institutional level (e.g., district hospitals, district collectorates, village offices, high schools, etc). The selected institutions prepared institutional plans outlining their infrastructure requirements, purchase needs for equipment, consumables and other items, including training for staff in 2004–05. District-level review committees have been constituted to monitor and review the implementation of these projects. Part of the Program proceeds and the $6.5 million GON TA grant were used to fund

the improvements outlined in the plan. A 3-day training program was organized in 14 locations covering about 45,000 persons from the 2,586 institutions involved on how to carry out the plan.

13. Some service delivery projects support the monitoring and evaluation of the service delivery. For example, the Baseline and Citizens' Survey was commissioned by the MGP Department to establish baseline citizen's perception data for services offered by institutions selected under the SDP. The study is currently under way. MGP has commissioned a Baseline and Citizens' Survey to record baseline data and to gauge the perception of the community regarding service quality. The purpose is to establish a benchmark for monitoring and further improvements. Another initiative called '*Sevana Mudra*' (service mark) along the lines of the U.K. Charter Mark was launched on a pilot basis to identify measurable indicators of performance for both institutions and individuals engaged in the delivery of services. Currently, 42 institutions out of the 2,586 institutions participating in the SDP are covered under *Sevana Mudra*.

14. *Sevana Mudra* emphasizes aligning investment in infrastructure and capacity building with service improvements. The initiative has been combined with a certification program called "charter mark status." Forty six institutions out of the 2,586 institutions participating in the SDP are covered under the *Sevana Mudra* project, but only 28 institutions have implemented this initiative. The Performance Improvement Circles (PIC) and the Client Consultation Circle (C3) have provided inputs aimed at improving service standards. The institutions have prepared plans identifying necessary requirements in the areas of additions to the existing infrastructure, capacity building for the employees and the clients, and funds required for recurring expenditure towards service delivery improvement. The TA provided by Quality Circle Forum of India, Hyderabad, provided training on techniques ranging from sorting out, rearrangement, cleaning up and sanitation, personal hygiene, and discipline. Quality circle has been piloted in 45 service delivery institutions.

14. Other projects target more specific objectives. Some examples include:

(i) The DC*SUITE Project for progressive computerizing of district collectorates. This is an integrated suite application of functional areas including a workflow-based file management system, a public grievances monitoring system, and a revenue recovery management.

(ii) Hospital kiosks,[1] for issue of birth/death certificates within 24 hours of reporting the event from the hospitals. Currently, 110 hospitals have such kiosks.

(iii) Police Portal for Community Interaction and associated services under the e-governance program.

(iv) Around 400 information technology (IT) access points, called *Akshaya Centers*, have been set up in Malappuram district to facilitate information exchanges between government and citizens and provide e-services such as e-payments.

15. Supported by the Program, the KG also approved a social audit policy and an asset renewal policy to enhance service delivery. The social audit policy, approved in August 2005, was based on the guidelines provided by the Government of India and some village-level experiments in Kerala. The policy is currently being tested as an action research project under

[1] In the case of a child born at home, the parent has to make an application to the Municipality/Corporation or the designated authority with details within 21 days. The details are then fed into the computer and a computer-generated certificate is issued to the applicant. It should be noted that most births take place in hospitals in Kerala.

MGP with respect to health, education, water supply, and sanitation in 27 village *panchayats*. KG approved an Asset Renewal Policy in October 2002. An Asset Renewal Fund was established with Rs400 crores out of which an amount of Rs135 crores came from the ADB loan proceeds under the MGP. Initial idea in establishing this fund was to create a separate Fund consisting of a part of the budget-line of the various departments and the Fund should grow through making investments. The Fund manager would use money from the Fund for asset renewal. Later it was felt that the Fund could not grow by investments and so the dynamic aspect of the Fund was dropped. Thus, it became a small Fund consisting of the contributions from the various departments out of their annual budget lines. The effectiveness of the Fund for the use of asset renewal has thus been reduced and the sustainability of the Fund is an important issue for consideration. Currently, specific rules for the operation of the Asset Renewal Fund are still in the process of finalization. However, the decision of the state government to prioritize the use of funds for service delivery improvement programs has delayed the actual asset renewal. Currently, about 2,600 institutions covered under the SDP have an asset renewal component. The MGP has only approved 88 institutional plans. The possibility of resources being spread too thinly also poses challenges.

16. Another piece of legislation, which has implications for service delivery, is the Kerala Right to Information Act which came into force in 2005. This legislation has the potential to provide better access to information by the public and make the Government more transparent and accountable. However, more time is needed to assess how the legislation is implemented and what impact it will have on service delivery and operations of the Government.

D. Institutional Arrangements for Program Management

17. KG has constituted a cabinet subcommittee under the chairmanship of the chief minister and a MGP steering committee chaired by the chief secretary to guide and direct MGP and to report on progress to the Council of Ministers in 2002. The set up of these two committees was promoted by the consideration to have a high powered cabinet subcommittee (consisting of some Ministers) under the chief minister to approve broad policy approaches and organizational aspects of MGP, while the MGP steering committee chaired by the chief secretary was formed for overall coordination, implementation, and monitoring of the program. Thus, the two committees shoulder different responsibilities but work for the same goal of improving government administration. The cabinet subcommittee under the chairmanship of chief minister did not meet frequently. MGP steering committee under the chairmanship of chief secretary consisted of secretaries (around 40 in number) turned to be an unwieldy body to have periodic meetings. Thus, a smaller committee, viz. Empowered Committee, was set up for effective operation. The steering committee then became redundant and was merged with Empowered Committee, and was called Steering and Empowered Committee. The committee has the powers to accord administrative sanction for proposals up to Rs5 million (now enhanced to Rsl.0 crore). There are five subcommittees, which receive assistance from task teams for preparation of the detailed implementation plans for the MGP themes. Secretaries of relevant implementing departments take the responsibility for delivery of their initiatives/projects.

18. An MGP Secretariat, entitled the General Services MGP Department (MGP Department) was formed and the MGP secretary was appointed on 13 September 2002. The MGP secretariat played an important role in establishing the MGP on an institutional platform that carries stakeholder consultation, coordination across state government departments and with LSGs, and program management and support. Compared to conventional project management units, the MGP Department had the powers and authority of a Government Department headed by a senior civil servant. It possessed better flexibility and freedom to deal with other

departments and reporting directly to the chief secretary. The secretary also had direct access to the Ministers. It is thus a more effective organizational form than a project management unit, which essentially has to work under a department.

19. The MGP Department was specifically created to carry out MGP initiatives. The setting up of this department reflected the importance and priority KG placed on modernizing government. The establishment of this department was also underpinned by the intension to establish a focused and targeted institutional platform for implementing and coordinating the MGP initiatives under the Program. The MGP department is thus a special purpose department and as such is transitional in nature. Staff were drawn from various government departments. They were supported by consultants and young professionals. As originally contemplated, MGP is a 5-year program of institutional change with two subprograms starting from December 2002, though subprogram 2 has not yet materialized. As subprogram 1 was completed in 2005, and the GON TA fund drew to a close in September 2006, most staff has returned to their original departments.

E. Assessments

20. The major achievement of MGP lies in that it has coordinated the implementation of numerous service delivery initiatives across a large number of government departments and institutions. The capacity of the MGP to carry out this role was enhanced by the fact that the MGP was set up as a separate special purpose department within the umbrella of the General Administration Department without having to go through the normal ladder of bureaucratic hierarchy. This institutional set-up conferred flexibility, and enabled the mobilization of skilled staff drawn from different departments. Arrangements for long-term consultancies like that provided by the Procurement Service Provider, Administrative Staff College of India, and Tata Consultancy Services, strengthened the functioning of the MGP. The use of young professionals as Program executives at the district level was also a positive feature. The MGP benefited from high level political and public servant support.

21. Perhaps the biggest problem of the MGP lies in the sustainability of the program. Despite the implementation of numerous specific initiatives, systemic reform has not been carried out to improve service delivery efficiency. This is further manifested in four levels.[2] First, there is no effective incentive mechanism to motivate, encourage, and reward good performance, nor is there a mechanism which makes service providers more accountable.[3] Second, little consideration has been given to providing consumers with choices. This is especially true for lower income families who rely more on services from the public sector. Thirdly, no effective monitoring and evaluation systems on service delivery have been developed. While social auditing was a part of the program, the action was slow and it is only experimented with in 27 out of about 1,000 village *panchayats*. Other initiatives such as the Service Mark are generally being experimented with in less than 50 institutions out of the total of about 30,000 in the state. Fourth, little consideration was given to cost recovery. As such, the initiatives, although numerous, are technical in nature and have not involved deep-rooted institutional and policy reforms.

22. The integration of the MGP and fiscal reforms influences sustainability. Service delivery and fiscal reforms are closely linked. The quality and volume of public service delivery cannot

[2] For more discussions, see the program completion report main text on Evaluation of Effectiveness.
[3] In the education sector, for example, an “accreditation” system for schools was considered but could not be carried out due to teacher opposition.

be improved without fiscal resources. On the other hand, wasteful and inefficient public service delivery adds to the fiscal burden. Fiscal reforms have not touched upon service delivery efficiently through budget management and expenditure restructuring, while service delivery initiatives did little to augment fiscal resources or to use limited resources most efficiently, although making service delivery efficient was a stated objective.

23. The disconnection between these two components undermines the effectiveness of reforms and sustainability of the outcomes. While the MGP and fiscal reforms starting from late 1990s were propelled by an emerging fiscal crisis, as noted earlier, the actual implementation of the reforms seems to have drifted away from the core issues that made reforms a necessity in the first place.

F. Ways Forward

24. Further reforms in MGP must take the sustainability of the program into consideration. As such, reforms need to involve institutional changes that strengthen the incentives for, and accountability of, service providers, and empower the end users. There is also a need to take account of the limited resources available for public service delivery. As such, while the equitable distribution of services is desirable, the trade off between equity and efficiency needs to be carefully managed. Cost recovery needs to be carefully considered to both augment resources and improve the efficiency of service delivery. Reforms must also take sound public finance as a pre-requisite for improving service delivery and MGP. After all, the very factor that prompted KG to undertake fiscal reforms and MGP was the emergency of a fiscal crisis in the late 1990s which threatened the very existence of the Kerala Development Model.

STATUS OF COMPLIANCE WITH LOAN CONDITIONS AND COVENANTS

A. CONDITIONS FOR THE RELEASE OF THE SECOND TRANCHE

Conditions	Ref in Loan Agreement	Status of Compliance at 2nd Tranche Release	Status of Compliance at the Program Completion Report Mission
Reform of Public Finances and Financial Management			
1. MTFF, Revenue Enhancement, and Fiscal Responsibility			
(i) Revised MTFF with summary targets in conjunction with FY2004 State Budget, published in the State's Budget in brief for FY2004.	Loan Agreement, Attachment 2 to Schedule 3, page 19	**Fully complied with.** Summary fiscal targets including consolidated statement on receipt and expenditure for 2004/05 summary State Budget published in (BIB) on 21 January 2004. MTFF not published in BIB, but included in the government of Kerala's Medium-Term Fiscal Policy and Strategy Statement for Kerala 2004/05 to 2006/07 published on 23 January 2004 in compliance with section 3 of the Kerala FRA (2003) (the Act). The Act requires the state government to report to the legislative assembly the medium-term policy statement that includes a 3-year rolling target for fiscal indicators.	Medium term Fiscal Policy and Strategy Statement presented in the State Assembly on 23 June 2006 along with the revised Budget in compliance with the Kerala FRA (2003).
(ii) Legislation on Cap on the State Guarantees enacted and brought into force.	Loan Agreement, Attachment 2 to Schedule 3, page 19	**Fully complied with.** The Kerala Ceiling on Government Guarantees Act (2003) was approved on 17 September 2003 and made effective on 5 December 2003. The Act establishes: (i) total annual outstanding ceiling on government guarantees set at Rs140 billion (equivalent to $3.2 billion and to just under 14% of GSDP), (ii) a GRF based on a guarantee commission equivalent to a minimum of 0.75% per annum of the value of the guarantee and to be charged and remitted to the public accounts of the state, and (iii) the state government will not extend any future guarantees unless outstanding guarantees are fully paid. Draft rules for GRF have been prepared and await the governor's assent, expected in March 2005. The ceiling on guarantees is strictly enforced. As of November 2004, Rs5.6 billion of new guarantees have been issued since the Act was brought into force and Rs42 million of commission fees collected under the state's Consolidated Fund. Until the GRF rules come into force, all payments toward invoking of government guarantees will be paid out from the state's Consolidated Fund.	The Kerala Ceiling on Government Guarantees Act (2003) was approved on 17 September 2003 and made effective on 5 December 2003. Total annual outstanding ceiling on Government Guarantees was set at Rs14,000 crores, equivalent to just under 14% of GSDP. As on 1 April 2004, the total guarantees were Rs13,995 crore which came down to Rs12,315.96 crores as on 1 April 2005. During 2005-2006, fresh guarantees for only Rs42 crore were given. The figures on 1 April 2006 are being collected. The risk weighing of guarantees is being constructed and the database is being updated. During 2004–2005, Rs50.82 crore was collected as Guarantee Commission. The corresponding figure for 2005–2006 is Rs69.22 crore.

Conditions	Ref in Loan Agreement	Status of Compliance at 2nd Tranche Release	Status of Compliance at the Program Completion Report Mission
(iii) Current revenue deficit of KSEB for the FY2004 financed by the state from its revenue and capital accounts in accordance with the policy decision on Financing of KSEB deficit.	Loan Agreement, Attachment 2 to Schedule 3, page 19	**Fully complied with**. As part of the understanding in the agreements in the power sector between the governments of India and Kerala, the latter committed on 17 November 2002 to assist KSEB in bridging its revenue deficit. Accordingly, the state government released Rs7.6 billion for this purpose covering the KSEB revenue deficit from 2002/03 to 2004/05. An additional amount of up to Rs1.6 billion (equivalent to $36.6 million) will be paid for the year 2005/06 as per agreement if there is a revenue shortfall.	From 2002-2004, a total amount of Rs756.46 crores was provided as budgetary support to KSEB. KSEB has taken measures to improve its financial performance over the past few years, including strengthening the energy audit, enhancing the Anti-Power Theft Squads, bringing down the transmission and distribution loss from around 31% in 2001/02 to 23% in April 2006, reducing the KSEB employee-size from 32,000 to 25,000 in 5 years, and the swapping of high cost debt. Consequently, the KSEB reduced the deficit from Rs1316.43 crores in the year 2001/02 to Rs144.58 crores in 2005/06.
(iv) VAT system, in accordance with the Borrower's requirements, introduced for the state	Loan Agreement, Attachment 2 to Schedule 3, page 19	**Substantially complied with.** The legislative assembly approved the Kerala Value Added Sales Tax Bill (2002) in February 2003 and was ready for assent of the president of India. In addition, the state government undertook the necessary steps to prepare for implementation of the new law by 1 April 2003, including the introduction of tax forms, systems, publicity campaigns, and training. However, due to a change in policy at the national level, the central Government decided to defer implementation of VAT across India. The state government is ready to introduce VAT, announced to become effective on 1 April 2005. All arrangements have been made in this regard.	Legislative Assembly approved the Kerala Value Added Sales Tax Bill (2002) in February 2003. KG undertook the necessary steps to prepare for implementation of new law by 1 April 2003, including the introduction of tax reforms, systems, publicity campaigns and training. The state switched over to the VAT system with effect from 1 April 2005 as soon as the Government of India approved it. Actual collection was lower compared to the average fixed for the state in tune with the collection under Kerala Goods and Services Tax Act. Government of India provided the State a compensation package of Rs692 crores in 2005–2006. The state is confident that collection is picking up based on figures from the first 3 months of the FY2006/07.
(v) Legislation on State Fiscal Responsibility enacted and brought into force.	Loan Agreement, Attachment 2 to Schedule 3, page 19	**Substantially complied with.** The Kerala FRA 2003 was approved on 17 September 2003 and brought into force on 5 December 2003 including the state government presenting to the legislative assembly progress in achieving fiscal objectives. Supporting rules and regulations have been prepared, though they still await the governor's assent, expected in March 2005. Under the Act, an independent PERC is to be established (first across states in India) to monitor the state government's fiscal performance and to be responsible for preparation of review report. The selection of PERC members was halted following a change of state government in August 2004, and a decision by chief minister, minister of finance, and leader of the opposition on appointment of members will be taken in second quarter of 2005.	Kerala was one of the first five states that enacted FRA, by bringing it into force on 5 December 2003. Supporting Rules and Regulations were also framed and brought into effect to operationalize the Act. The target figures of RD and FD for the respective years are being amended in line with the Twelfth Finance Commission recommendations according to which the RD has to be balanced by 2008-2009 and the FD has to be brought down to 3% by 2008-2009. The PERC has been established and first report of the Committee was tabled in the Legislature in June 2006. Despite the passing of the FRA, RD and FD remain high and the Finance Department is pessimistic about achieving the FRA targets by 2009.

Conditions	Ref in Loan Agreement	Status of Compliance at 2nd Tranche Release	Status of Compliance at the Program Completion Report Mission
(vi) Rate of conveyance (comprising aggregate of stamp duty, surcharge and registration fee) reduced by at least four percentage points	Loan Agreement, Attachment 2 to Schedule 3, page 19	**Fully complied with**. The Kerala Stamp (Amendment) Act 2004 dated 26 February 2004 has reduced the rate of conveyance from 15.5% to 8% in municipal corporations, from 14.5% to 7% in municipalities other than corporations and from 12% to 6% in *panchayats*. Consequently, the "fair" value of price of land was draft notified in the *Official Gazette* in October 2004. However, the state government is required to wait until finalization of consultation (public scrutiny) process before finalizing value (price). Revised values are to be brought into force by April 2005.	The process of fixation of fair value of land has not been completed so far. The rates of conveyance have been reversed back to their original levels, with effect from 1 April 2005.
2. Budgeting and Financial Management (vii) New Budget Cycle implemented (Full FY2005 Budget passed before 31 March 2004) with forward estimates for 2 years. (The forward estimates to integrate with the Investment Plan to protect capital investment in social sectors)	Loan Agreement, Attachment 2 to Schedule 3, page 19	**Fully complied with.** The state government modified the budgeting cycle and presented the full budget in January 2004, completed the scrutiny by the Subject Committee of Legislature and was ready to fully pass the budget in March 2004. However, the holding of general elections required a vote on account and not on the full budget for the first 3 months of the fiscal year. While 2-year forward estimates were not presented, the state government issued instructions through the principal secretary of finance on 3 December 2004 seeking heads of department to prepare forward estimates for plan and non-plan expenditures for 2006/07 and 2007/08. These forward estimates will be presented on an annual basis to the state assembly alongside the budget documents in the budget.	Fully complied with for 2004–2005 and 2005–2006. However, in 2006–2007, due to general elections in April-May, even though the full budget was presented in February 2006, only vote on account could be passed for the first 3 months of the fiscal year.
(viii) State financial accounts for FY2003 tabled in the State legislative assembly by not later than 31 October 2003.	Loan Agreement, Attachment 2 to Schedule 3, page 19	**Fully complied with**. SFAs for 2001/02 were vetted by the Comptroller and Auditor General of India on 30 October 2003. This represents the last stage before submission to the legislative assembly. However, as the assembly was not in session, the SFAs were tabled on 19 January 2004. SFAs for FY2002 were certified by Comptroller and Auditor General on 30 October 2004 and thereafter tabled in the legislative assembly on 1 December 2004.	SFA for 2003–2004 was submitted before Legislative Assembly on 31 January 2005. SFA for 2004-2005 was presented to the Assembly on 15 February 2006. SFAs can be presented in the Legislature only when it is in session.
Core Government Functions			
1. Payroll and Personnel Computerized System			

Conditions	Ref in Loan Agreement	Status of Compliance at 2nd Tranche Release	Status of Compliance at the Program Completion Report Mission
(i) Integrated personnel and payroll management and computerized system for State's Secretariat, and the Commercial Taxes Department, implemented	Loan Agreement, Attachment 2 to Schedule 3, page 20	**Substantially complied with.** The data transfer plan and orders for the hardware, software, and training have been completed. There is a period of testing required followed by a 3-month period or parallel running before the Payroll for the Secretariat is fully live in June 2005. The payroll for the Commercial Taxes Department is scheduled for implementation in second quarter of 2005. The changes in business processes and the resulting changes in roles and responsibilities need to be addressed as a priority activity before the payroll is implemented. Technical assistance from the procurement service provider may be required for this.	A web-based Personnel Administration and accounts software for government establishments has been developed. Permanent Employee Number has been given to all employees of General Administration Department and Finance Department. This addresses all requirements in service, salary, income tax and accounts matters. The centralized database helps in quick decision-making and applying rules and regulations uniformly for all employees. There is provision to send alert messages to employees, when payments are credited and provision to generate identity cards. The system has been successfully implemented in the Government Secretariat, General Administration Department, and Finance and is in constant use. The data entry work has been completed in the High Court of Kerala and is in progress in the following department: Police, Public Works, Revenue, Commercial Taxes, Vocational, Higher, Secondary, Technical Education and General Education. Work in these departments is likely to be completed by the end of 2006–2007.
2. Infrastructure projects review (ii) A plan (covering Irrigation and Harbor Engineering Departments) identifying termination of unproductive infrastructure projects based on the Policy on long pending infrastructure projects, approved, circulated to relevant departments and published on a dedicated website	Loan Agreement, Attachment 2 to Schedule 3, page 20	**Fully complied with.** The projects for termination have been identified and a committee for inspection has been formed. A schedule for inspections has been approved and is published on the MGP website. In addition, inspection of two long-standing projects has been completed.	Eleven projects were identified under the Initiative – 4 irrigation projects, 5 fishing harbors and 2 ports. Multi-disciplinary teams were constituted for detailed study about these projects in accordance with the approved policy. Final reports were prepared for seven projects. Draft reports are ready for four Projects. These reports were prepared after extensive field visits, public hearing and review of the available sources of database. The following actions were taken: 1. Prioritized action plans prepared for implementation of selected projects; 2. Land Acquisition Units were established to acquire land for speedy completion of the irrigation projects; and 3. Additional fund was provided for fast track completion.
3. Asset Management/ Renewal (iii) Assets renewed in accordance with the Asset	Loan	**Substantially complied with**. Assets are being	An Asset Renewal Fund was established with

Conditions	Ref in Loan Agreement	Status of Compliance at 2nd Tranche Release	Status of Compliance at the Program Completion Report Mission
Renewal Policy and the detailed implementation plans of the SIPs, utilizing Asset Renewal Fund	Agreement, Attachment 2 to Schedule 3, page 20	renewed in accordance with the Asset Renewal Policy and as part of the Service Delivery Project. An asset renewal fund has been established and an initial allocation has been made to 10 service delivery institutions. Almost all 2,600 service delivery institutions under SDP have an asset renewal component and the MGP Steering cum Empowered Committee has approved 88 institutional plans comprising sub registrar offices, hospitals, schools, and one police station. As part of the remodeling of district collectorates to enhance transparency and accountability in the provision of public services, assets were renewed on the basis of the Asset Renewal Policy and the SDP the pilot district collectorate of Palakhadd. In addition, an asset management system for LSGs has been developed and the system will be extended to cover state government assets.	Rs400 crores out of which Rs135 crores have been transferred from MGP funds under the Program. The Rules for operationalization of ARF are being finalized by General Administration (MGP) Department in consultation with Finance Department. All assets of LSG's have been mapped and prepared in the form of a register. Digitization will be complete in 3 months times. After asset mapping, maintenance funds to the LSG's will be released on the basis of actual assets.
4. Efficiency enhancing measures, and Government restructuring/ rationalization of decision-making process (iv) Identification of surplus staff completed for all State departments and Secretariat. Not less than twenty percent (20%) of identified surplus staff reskilled and redeployed	Loan Agreement, Attachment 2 to Schedule 3, page 20	**Fully complied with.** 11,658 posts identified as surplus of which 4,578 staff have been redeployed to LSGs.	Fully complied with.
(v) All posts of redeployed staff abolished	Loan Agreement, Attachment 2 to Schedule 3, page 20	**Fully complied with.** According to Government Order of 19 November 2003, 3,570 posts were abolished. An additional 3,510 posts were identified as surplus and declared supernumerary.	No new post has been created since 2003. Information about elimination of supernumerary posts is being collected by Personnel and Administrative Reforms Department from various departments.
(vi) Functional review completed (in accordance with State approved functional review methodology) and implementation plan for restructuring, of the State's Secretariat and the Commercial Taxes Department, approved and notified by the State	Loan Agreement, Attachment 2 to Schedule 3, page 20	**Partly complied with.** Functional review methodology for the Secretariat has been approved by the Council of Ministers. Functions have been classified, staff trained, and a plan for conducting the functional review for the Secretariat approved and notified by the state government. Additional TA has been secured through the procurement service provider to assist with the second phase, which is concerned with conducting the functional review and restructuring the Secretariat. This phase will be completed by end-2005	Partly complied with. Functional review (FR) methodology for the Secretariat was approved by the Council of Ministers. Functions have been classified, staff trained and a plan for conducting the FR for the Secretariat was approved and notified by the State. A SSTA from ADB (SSTA 3870) was secured to assist the second phase of FR. This phase was expected to be completed by end 2005 and would have included transfer of delegated functions to other government institutions. But FR in

Conditions	Ref in Loan Agreement	Status of Compliance at 2nd Tranche Release	Status of Compliance at the Program Completion Report Mission
		and will include transfer of delegated functions to other government institutions. The functional review and associated restructuring of the Commercial Taxes Department has been deferred until the introduction of VAT.	the Secretariat has not been fully carried out. Inspection teams with staff from P&ARD had been formed to conduct inspections in Secretariat departments and the offices of the Heads of departments, but FR had to be abandoned due to staff opposition Restructuring of Commercial Taxes Department has started and is centered around implementing VAT.
(vii) Quarterly performance and progress report of MGP (in accordance with the Project Performance Management System) against the detailed implementation plan of the Strategic Implementation Plans (SIPs) as referred in paragraph 6 of Schedule 5 to this Loan Agreement, placed before the MGP Cabinet Sub-Committee and published on a dedicated website	Loan Agreement, Attachment 2 to Schedule 3, page 20	**Substantially complied with.** The MGP comprises 56 initiatives covering state and local governments and is implemented in 17 departments. There was an initial delay in reporting progress on a quarterly basis. This was partly due to the time and resources required to design and implement the underlying monitoring and reporting systems and in recruiting appropriate staff. Progress covering four quarters for the period October 2003 to September 2004 has been placed before the MGP steering committee and published on the MGP website. The state government has developed innovative e-based PPMS for the MGP, which is updated and accessed interactively by over 150 MGP users. Results-based management techniques have been utilized for reporting progress. There is a need for the PPMS reports to be streamlined and focused before incorporation into the quarterly monitoring reports.	The MGP comprised of 100 initiatives of which 49 are under implementation, covering state and local self-government in 17 departments. PPMS-1 software gives the details of the various general initiatives under MGP. However, PPMS had not been used by the end user departments to the desired extent. The administration report on MGP initiatives for 2005–2006 is being finalized.
5. Service Delivery (viii) A plan for improvement of service delivery (the plan) shall be prepared in accordance with Service Delivery Policy approved and notified by the State and being implemented for: (i) one priority service in a minimum of three different Service Delivery Departments; and (ii) for Primary Health Care Services in 14 Village *Panchayats*, 3 Municipal Councils, and 1 Municipal Corporation	Loan Agreement, Attachment 2 to Schedule 3, page 20	**Fully complied with.** The service delivery improvement plan has been approved and notified by the state government. The plan is being implemented in accordance with the approved Service Delivery Policy. Policy for 2,600 service delivery institutions including 99 primary health care centers in 14 districts covering village *panchayats*, municipal councils, and municipal corporation. In addition, the SDP includes the Secretariat, 14 municipalities, 5 municipal corporations, 14 district collectorates, 4 district and 14 *taluk* hospitals, 17 community health centers, and 224 lower primary schools. Departments covered include Revenue, Education, and Home.	The service delivery plans of the 2,587 institutions which were selected to implement the service delivery projects are in different stages of implementation.

Conditions	Ref in Loan Agreement	Status of Compliance at 2nd Tranche Release	Status of Compliance at the Program Completion Report Mission
(ix) Social audit completed (in accordance with the Social Audit Policy) for service delivery outlets in accordance with the first annual implementation program under the said Policy	Loan Agreement, Attachment 2 to Schedule 3, page 20	**Fully complied with.** In accordance with the working draft social audit policy, the first annual implementation plan was prepared by all 991 *gram panchayats* through *gram sabhas* and as part of annual plan preparation for FY2005. A social audit was completed in accordance with first annual implementation plan and the translated documents were presented as a sample in five *grama sabhas*. The experienced gained has informed the Social Audit Policy, which has been approved and notified.	A Social Audit Policy has been brought out by the state government. This is being tested as an action research project in 27 *Gram Panchayats*.
6. Transparency and right to information (x) Legislation on Right to Information enacted and brought into force	Loan Agreement, Attachment 2 to Schedule 3, page 20	**Substantially complied with.** The central Government enacted the Freedom of Information Act, 2002. In February 2003, the central Government advised state governments that the Act also applied to public authorities administratively connected with the state and directed states to make rules for giving effect to the provisions of the Act. Rules that were formulated by the state government in conformity with central legislation were forwarded to the central Government on 23 January 2004 for approval which is still pending. The state government has proceeded with implementation of a number of initiatives to provide information to the public. In addition, the state government, on its own, has provided the right to information in LSGs through amendments to Local Government Acts and operationalized it through rules.	On the basis of the Freedom of Information Act 2002 enacted by the Government of India on 6 January 2003, the Kerala Legislative Assembly passed the Kerala Right to Information Bill in 2005. This enactment ensures that public information is available to the people of Kerala as an enforceable right and in the process to make Government more transparent, open to public scrutiny and thereby more efficient. The Service Delivery Policy of KG directs all departments and Government institutions to prepare and publish Citizen's Charter so as to make their functioning more transparent. According to the provisions of the Act, the Government has constituted a State Information Commission with a Chief Information Commissioner and four Information Commissioners. All Departments have Public Information Officers for making available the information, which the public asks for. The State Information Commission is an appellate body.
Local Self Governments (LSGs)			
Strengthening of LSGs (i) LSG Action Plan implemented and progress report prepared against performance targets for a period of at least twelve months from date of approval of the LSG Action Plan by the State	Loan Agreement, Attachment 2 to Schedule 3, page 21	**Fully complied with.** The action plan covering the institutionalization phase of LSGs was approved in November 2002. Milestones for implementing the action plan were developed through a consultative workshop and established in December 2002. A report on progress against the milestones covering 22 major actions was issued on 31 October 2004. There have been significant achievements under this policy measure.	Implementation of many of the action points is underway.

Conditions	Ref in Loan Agreement	Status of Compliance at 2nd Tranche Release	Status of Compliance at the Program Completion Report Mission
(ii) Rationalization of functions of LSG Department and Rural Development Department completed	Loan Agreement, Attachment 2 to Schedule 3, page 21	**Fully complied with.** The main functional area requiring rationalization concerned public works and this has been completed. A clarification order was issued on the roles and responsibilities of the LSG and Rural Development Departments and a coordination committee comprising ministers, secretaries, and heads of both departments has been established to address any issues arising not covered in the clarification order. The decision of the coordination committee is binding on both departments.	
(iii) Decision on the merger of DRDAs with District Panchayats implemented in accordance with the provisions of the Constitution of India and recommendations of the Eleventh Finance Commission	Loan Agreement, Attachment 2 to Schedule 3, page 21	**Fully complied with.** The Constitution (Article 243G) provides for devolution, that is, the empowerment of PRIs to function as institutions of self-government subject to such conditions as the state may, by law, specify. However, the Eleventh Finance Commission recommends that the ministries of Rural Development and Urban Development take the lead in addressing the impediments to PRIs operating as institutions of self-government, particularly as DRDAs are operating as instruments of the central Government for the planning and implementation of many programs and schemes. The issue was discussed at the first roundtable conference on PRIs on effective devolution, held by the ministers in charge of the two ministries on 24–25 July 2004. As the ministries of Rural and Urban Development have issued no guidance, the state government has taken a decision on the merger and the first step in the process is to undertake a study of the experience of states that have abolished DRDAs, like Karnataka, Madhya Pradesh, and West Bengal. A joint team comprising Planning, LSG, and Rural Development departments has been established to undertake the study.	Government has issued orders merging DRDA with District panchayats. A government order was issued in 2001 (GO (MS) 87/2001/LSGD dated 27 March 2001) merging DRDA with District Panchayats. This order was later kept in abeyance. Recently Government in accordance with G.O. (MS/132/2006/lsgd dated 5 June 2006) have lifted the stay and operationalized abolition of DRDAs.
(iv) New Rules for property assessment in accordance with the Panchayat Raj Act, 1994 and Municipalities Act, 1994 (as amended in 1999), brought into force	Loan Agreement, Attachment 2 to Schedule 3, page 21	**Partly complied with.** New rules have been framed but can only come into effect if amendments are made in the relevant provisions of the Kerala Panchayat Act, 1994 and the Municipalities Act, 1994. Draft bills have been sent to the legislative assembly for approval.	Government has taken a decision that Property Tax Rules will be framed to determine Property tax on Plinth area basis. This was pronounced by the Governor in his address to the Legislative Assembly on 16 June 2006.

Conditions	Ref in Loan Agreement	Status of Compliance at 2nd Tranche Release	Status of Compliance at the Program Completion Report Mission
(v) Progress report on implementation of Eleventh Finance Commission Guidelines for maintenance and audit of LSG accounts issued by the state	Loan Agreement, Attachment 2 to Schedule 3, page 21	**Fully complied with.** Based on the recommendation, the state government issued orders to LSGs to adopt the new accounting and budget formats with effect from 1 April 2004. In accordance with the Guidelines, the C&AG of India is providing technical supervision of audit comprising audit planning, annual transaction audit of 10% of LSG Institutions by random selection, supplementary audit of 10% of LSG institutions by the Local Fund Audit, and vetting of inspection and audit reports for a period of 5 years. The state government has also ordered that comments of the C&AG be included as a separate part of the audit report of the director of the Local Fund Audit placed before the legislature. The Director of the Local Fund Audit works under the technical supervision of the C&AG.	New Budgeting and Accounting Manual for LSGs is under preparation as a TA under MGP. This is expected to be completed by September 2006.
(vi) Transfer of staff to LSGs completed and plan for transfer of staff budgets prepared	Loan Agreement, Attachment 2 to Schedule 3, page 21	**Substantially complied with.** Staff have been transferred and a policy decision has been taken to refer the technical details associated with the transfer of staff budget to the Third State Finance Commission (as a specific item in the terms of reference) established in August 2004. The recommendations are due in August 2005.	The report of the Third State Finance Commission was published in November 2005. This mentions that transfer of staff to LSG Departments would be found mostly by redeployment. Specific details are being worked out by the LSG Department and Finance Department. A final decision regarding transfer of staff budget is yet to be taken.
(vii) Capacity building in financial management for LSGs and community organizations under implementation in accordance with the Policy on Capacity Building in Financial Management for LSGs and Community Organizations	Loan Agreement, Attachment 2 to Schedule 3, page 21	**Fully complied with.** The Capacity Building Policy in Financial Management adopts a four-fold approach covering human resources development, setting up legal entitlements, introducing simple and effective operating systems, and strengthening the institutional arrangements. The policy was approved in October 2002 and many of the actions have been incorporated into the LSG Institutionalization Action Plan. In addition, the KILA has developed and implemented 10 different training courses for building capability in new accounting systems, improving the understanding of elected members of local body systems, building capability of urban bodies to cope with requirements of public private partnership projects, and building capability for improved plan formulation. Around 60,000 persons have been trained including non-government organizations. A methodology for trainer and trainee evaluation is being prepared.	KILA is continuing with the process of capacity building and financial management for the newly elected representatives of LSGs. *Kudumbasree* is organizing capacity building programs for neighborhood groups of poor women.
(viii) Decision taken by the state on recommendations of the Second State Finance Commission and implemented	Loan Agreement, Attachment	**Fully complied with.** The basic recommendations relate to the devolution of funds to LSGs. In this respect, the recommended release of 3.5% of state	The Third State Finance Commission constituted in September 2004 published its report in November 2005. The recommendations of the commission are

Conditions	Ref in Loan Agreement	Status of Compliance at 2nd Tranche Release	Status of Compliance at the Program Completion Report Mission
	2 to Schedule 3, page 21	taxes as general purpose grants and 5.5% as a maintenance grant have been fully accepted by the state government and funds have been provided for this in the state budget for 2004/05 following a vote on account proceedings. However, on plan funds (excluding state sponsored schemes), the state government has decided to maintain the current order of funding and not make an explicit commitment to provide no less than one third the annual size of the state plan. Furthermore, contrary to the recommendation that the grants from the Eleventh Finance Commission to LSGs should be passed down as such over and above the other grants, the state government has decided to include this as an integral part of the plan funds.	under consideration of the Government, including for devolution of funds for local bodies.
Poverty Reduction and Minimum Needs Program			
Antipoverty measures (i) Anti-poverty Subplan prepared, approved and notified by the State (the plan to take into account the findings of the Study)	Loan Agreement, Attachment 2 to Schedule 3, page 21	**Substantially complied with.** As part of the Tenth Five-Year Plan, all 1,215 LSGs have prepared antipoverty subplans based on guidelines prepared by the State Planning Board. The subplans have been consolidated for FY2002–2003. A study on subsidies has been commissioned to inform the antipoverty subplan. The experience gained from the LSG subplans and the findings of the study will contribute to the development of a coordinated state plan for FY2005–2006.	The antipoverty subplans of the LSGs are being consolidated every year. However, developing coordinated state plan using the entitlement index has been delayed and possibly can only be done some time in 2006–2007.
(ii) A system for periodic poverty monitoring and reporting (utilizing community-based and state's processes) designed, and implementation plan thereof approved and notified by the State	Loan Agreement, Attachment 2 to Schedule 3, page 21	**Fully complied with.** In September 2004, the state government approved a strategy paper and a plan of action for the periodic monitoring and reporting of poverty. The monitoring of poverty will be tried on a pilot basis and universalized by April 2005.	The study on Community Based Monitoring and Tracking of Funds is nearing completion. Based on this a system will be designed. This is a TA under MGP, which is funded by Royal Netherlands Embassy.
(iii) Policy for enabling access to credit by the poor (as identified in the poverty census and poverty database of the state), approved and notified by the State	Loan Agreement, Attachment 2 to Schedule 3, page 21	**Fully complied with.** The policy has been approved and notified by the state government after a process that drew on inputs from selected experts and state-wide consultations including *Kudumbashree* and the state-level Bankers Committee.	The database is being updated.

Conditions	Ref in Loan Agreement	Status of Compliance at 2nd Tranche Release	Status of Compliance at the Program Completion Report Mission
State Level Public Enterprise (SLPE) Reform			
Public Sector reforms (i) Backlog on external audit of at least three statutory public boards as identified by the State, reduced by at least 2 years	Loan Agreement, Attachment 2 to Schedule 3, Page 22	**Fully complied with.** Twenty-two statutory public boards have had their backlogs reduced by 2 years and are up to date; 11 have had their backlogs also reduced by 2 years and have 1 more year's audit before they will be up to date.	Statutory audit has been done up to 2004–2005 in the case of 22 companies and up to 2003–2004 in the case of 33 companies.
(ii) Policy on VRS for regular/permanent employees not covered under existing VRS Policy, approved and notified by the State	Loan Agreement, Attachment 2 to Schedule 3, Page 22	**Fully complied with.** A government order was issued on 24 June 2003.	Following announcement of Industrial Policy in 2001 and approval of PERC's and approach paper on SLPE reforms, VRS policy was approved and notified vide G.O. (P) No. 73/2003/ID dated 24 June 2003 which covers VRS to all categories of employees.
(iii) Policy on Social Safety Net for all categories of eligible employees, approved and notified by the State	Loan Agreement, Attachment 2 to Schedule 3, Page 22	**Fully complied with.** A government order was issued on 24 June 2003.	The SSNP was notified vide G.O. (P) No. 73/2003/ID issued on 24 June 2003. Welfare and Economic sustainability scheme under SSNP is being evolved through wider debates and consultations organized under initiative No. II.2.1 of MGP.

ADB=Asian Development Bank, C&AG=Comptroller & Auditor General, DRDA=District Rural Development Agency, FD=fiscal deficit, FR=functional review, FRA=Fiscal Responsibility Act, FY=fiscal year, KG=Government of Kerala, GRF=guarantee redemption fund, GSDP=gross state domestic product, KILA=Kerala Institute of Local Authority, KSEB=Kerala State Electricity Board, LSG=local self-government, MGP=modernizing government program, MTFF= Medium-Term Fiscal Framework, P&ARD=Personnel & Administrative Reform Department, PERC=public expenditure review committee, PRI=panchayati raj institution, PPMS=project/program performance management system, RD=revenue deficit, SDP=service delivery project, SFA=state financial accounts, SIPs= Strategic Implementation Plans, SLPE=state-level public enterprise, SSNP=social safety net policy, SSTA=small scale technical assistance, TA=technical assistance, VAT=value-added tax, VRS=voluntary retirement scheme.

STATUS OF COMPLIANCE WITH LOAN COVENANTS

B. COVENANTS UNRELATED TO THE TRANCHE

Covenants	Reference in Loan Agreement	Status of Compliance at Tranche Release	Status of Compliance at Mission
A. Loan Covenants from the Loan Agreement (Schedule 5)			
Implementation of Policy Reforms			
1. The Borrower shall cause the state to carry out the policies and actions in accordance with the schedule of policy reforms contained in the policy matrix as agreed upon between the state, ADB and GON and ensure that these shall continue to be in effect for at least the duration of the Program.	Loan Agreement, Schedule 5, para. 1 (a)	The state government has carried out the program with due diligence and efficiency and in conformity with sound public management, administrative, financial, engineering, and environmental practices and have performed the obligations under the Loan Agreement.	Fully complied with.
2. The Borrower shall ensure that the state shall carry out all its obligations as stipulated under this Schedule, the Loan Agreement and the Program Agreement, in a timely manner.	Loan Agreement, Schedule 5, para. 1 (b)	Government of India's	Fully complied with.
3. The state shall ensure that the Office of the Chief Secretary and the Finance Department of the State shall be the Program executing agencies.	Loan Agreement, Schedule 5, para. 2 (a)	Fully complied with.	Fully complied with vide (GO) MS 358/02/ (GAD) dated 26 October 2002.
4. The state shall ensure that the MGPSC shall assist the Program executing agencies and shall be responsible for overall coordination, effective implementation, and monitoring of the Program. The MGPSC shall be headed by the Chief Secretary and comprise the Principal Secretary Finance, Principal Secretary Power, the MGP Secretary and all secretaries of departments participating in the Program. The MGPSC shall meet at least once every month to review and report on the progress and performance of the Program, to (i) the MGP Cabinet Sub-committee; and (ii) the monthly meeting of the Secretaries of the state.	Loan Agreement, Schedule 5, para. 2 (b)	Fully complied with.	Report on Project Administration contains details about MGPSC meetings and other related issues. MGPSC meets regularly and discusses issues.
5. The state shall ensure that the MGP Secretary shall (i) be responsible for the coordination and management of the Program; (ii) report to the Chief Secretary, and continue in the position on a full time basis for a reasonable duration to ensure	Loan Agreement, Schedule 5, para. 2 (c)	Fully complied with.	From October 2005 onwards Secretary MGP is also holding additional charge of other Departments.

Covenants	Reference in Loan Agreement	Status of Compliance at Tranche Release	Status of Compliance at Mission
continuity in the implementation of the Program			
Policy Dialogue			
6. The State shall keep ADB and GON, informed of, and from time to time exchange views with the ADB and GON, on the progress made in carrying out these policies and actions set out in the policy letter and the policy matrix in the formulation and implementation of new policies affecting the Program.	Loan Agreement, Schedule 5, para. 3	Being complied with through regular communication.	Being complied with through regular communication.
7. The State shall keep ADB informed of policy discussions with other international and bilateral aid agencies and shall allow ADB to comment on the same in so far as these affect the Program.	Loan Agreement, Schedule 5, para. 4	Being complied with through regular communication.	Not applicable.
8. The State shall continue policy dialogue and regularly exchange views and information with ADB and GON, on problems and constraints encountered during implementation of the Program and on changes to overcome or mitigate such problems and constraints.	Loan Agreement, Schedule 5, para. 5	Being complied with through regular communication.	Fully complied with.
9. The State shall approve and notify the detailed implementation plan of the SIPs (i) not later than 31 December 2002, for the first 12 months of the Program; and (ii) not later than 31 December 2003, for the next 12 months of the Program. The State shall also ensure that the Program is implemented in accordance with the detailed implementation plans.	Loan Agreement, Schedule 5, para. 6	Fully completed. Reports available on PPMS website and to be transferred by end June 2004 to main MGP website after technology upgrade of MGP server. Report of all quarters approved by the MGP Steering Committee. Report of April–June 2004 to be placed before the Council of Ministers.	Detailed implementation plans for entire programs are approved in GO (Ms) No. 345/03/GAD dated 26 November 2003. The Program is being implemented in accordance with the Detailed Implementation Plan.
10. Without limiting the generality of Section 2.02 of the Program Agreement, the State shall take all steps and actions, including the provision of staff resources and funds to ensure satisfactory completion, in a timely manner, of all outputs in the detailed implementation plans referred to in preceding paragraph 6 of this Schedule.	Loan Agreement, Schedule 5, para. 7	Funds are provided in the budget. Staff created in GO Ms 358/02/GAD dated 26 October 2002.	MGP Mission and staff created in accordance with vide GO Ms. 358/02/GAD dated 26 October 2002. Sufficient resources are provided in the budget for completion of activities listed in the Detailed Implementation Plan.
Community and Stakeholders Consultation and Participation			
11. The State shall ensure that the relevant components of the Program are implemented in consultation with and participation of the community,	Loan Agreement, Schedule 5,	Fully complied with.	Service delivery plans, Sevana Mudra institutional plans, anti-poverty sub-plans have been prepared in consultation and with the participation of

Covenants	Reference in Loan Agreement	Status of Compliance at Tranche Release	Status of Compliance at Mission
stakeholders and community representatives such as the non-government organizations and community based organizations.	para. 8 (a)		stakeholders such as elected representatives of the LSGs, neighborhood groups, and Parents-Teachers-Association. Implementation of Service Delivery and Sevana Mudra plans is being monitored by the stakeholders.
12. Without limiting the generality of clause (a) of this paragraph, the State shall ensure that appropriate institutional mechanisms are in place for communication and feedback on the relevant policy actions from the community and stakeholders.	Loan Agreement, Schedule 5, para. 8 (b)	Dedicated website *keralamgp.org* has been maintained and updated with facility for feedback.	Regarding the implementation of Service Delivery Project, the social audit policy is being tested out as an action research project in 26 panchayats. In Sevana Mudra, the stakeholders are grouped into Performance Improvement Circle and Client consultation circle which provide feedback on the services delivered and ensure that the services delivered are of a particular standard. The citizens charter was tested and evaluated through the neighborhood groups of poor women in some panchayats. Actions are being initiated.
Technical Assistance			
13. The State shall ensure that in carrying out the policy measures and activities included under the Program and Policy Matrix, due consideration shall be given to the findings and recommendations of any related technical assistance. The State shall also consult with and keep ADB and GON informed of the findings and recommendations of the technical assistance as may be provided by other bilateral agencies in relation to the Program.	Loan Agreement, Schedule 5, para. 9	Being complied with.	Recommendations of TA are considered and reviewed by the departments for policy changes and implementation. TAs by other development agencies are also utilized. For example, in TA for water supply and sanitation project the study report from Jalanidhi (Word Bank assisted water supply and sanitation project) is also being used.
14. The State shall allow ADB and GON to provide their comments on the findings and recommendations of the technical assistance, referred to in clause (a) of this paragraph, for consideration in the policy measures and other activities, as mutually acceptable to the State, ADB and GON.	Loan Agreement, Schedule 5, para. 10	Being complied with.	Being complied with.
15. The State, ADB, and GON shall exchange and draw on, in a timely manner, the necessary information and resources in the formulation and finalization of tranche outputs and implementation thereof, as included in the Policy Matrix and SIPs.	Loan Agreement, Schedule 5, para. 11 (a)	Completed.	Policy Matrix being updated.
16. In formulating the tranche outputs as indicated in clause (a) of this paragraph and the reform measures under the Program, including in this	Loan Agreement, Schedule 5,	Fully complied with.	Updated policy matrix.

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Loan Agreement, the State shall ensure that the findings, recommendations and mitigation measures of the Initial Poverty and Social Assessment (that means the study as carried out during the processing of the Loan), including follow up action therein, are carried out during Program implementation, all in accordance with clause (a) of this paragraph.	para. 11 (b)		
Power Sector Reforms			
17. The State shall seek KSEB to file the application for revision of tariffs before the KSERC within not more than 2 months of establishment of the KSERC.	Loan Agreement, Schedule 5, para. 12	**Fully complied with.** A tariff revision petition was filed by KSEB on 1 August 2003, beyond the stipulated 2 months from the establishment of KSERC due to difficulties in appointing committee members. KSERC's findings of December 2003 were that the state government shall finance the cumulative revenue gap of Rs5.6 billion in 2003/04. The Government fully complied with financing of KSEB deficit (see third action in Appendix 2 above). However, despite KSEB filing the petition, KSERC ruled that in the absence of details of service and the accurate data regarding category-wide consumption, it is not in a position to undertake the exercise on tariff rationalization.	The Kerala State Electricity Regulatory Commission (KSERC) was constituted on 28 November 2002. After the constitution of KSERC, the KSEB submitted petition on the Aggregate Revenue Requirement and Expected Revenue from charges (ARR & ERC) for 2003–2004, 2004–2005, 2005–2006, and 2006–2007 on 1 August 2003, 15 December 2003, 15 November 2004, and 30 November 2005, respectively. The commission has passed orders on this petition on 31 December 2003, 16 April 2004, 23 March 2005, and 30 March 2006, respectively.
Fiscal Matters			
18. The State shall prepare a mid-year report on its budget performance and required mid-year correction by not later than 31 January 2003.	Loan Agreement, Schedule 5, para. 13	**Fully complied with.** Under the obligations of the Kerala FRA, the Government presented the Medium-Term Fiscal Policy and Strategy Statement on 23 January 2004. The Act does not require the submission of a mid-term report. According to article 7 of the Act, "The PERC shall submit to the Government in such form and at such intervals as may be prescribed a review report giving full account of each item where the deviation from the fiscal target have occurred during the previous years". However, PERC is an independent body and does not constitute part of the state mechanism of government.	For the current year 2006–2007, budget was presented in the Legislative Assembly in February 2006 and vote-on-account passed. Thereafter, full budget was again presented on 23 June 2006 after the new Government took over.
19. The State shall take all steps necessary to ensure timely compliance with the Tripartite Agreement and the Letter of Shared Fiscal Goals and Objectives.	Loan Agreement, Schedule 5, para. 14	**Fully complied with.** A tripartite agreement on power sector reforms between the central Government, state government, and Reserve Bank of India (RBI) concluded a one-time settlement of KSEB dues to central public sector undertakings (CPSUs) up to 2006. As part of the agreement, the	

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		state government has issued 20 tax-free bonds for Rs579 million each to the CPSUs after waiving 60% of the surcharge. These "power bonds" are priced at 8.5% per annum and will be repaid at par on 1 October 2009. The state government is to treat the securitized amount of Rs11.6 billion as a loan to KSEB and that is to be converted into a grant at time of actual settlement. The state government has allocated Rs3.8 billion under a supplementary demand for grant to take care of the revenue gap for FY2004. However, exposure of the state budget on KSEB continues and mitigation measures on the fiscal risks are pending. On the LSFGO, the state government did take all steps necessary to comply with it in 2002/03. However, as the state government did not comply with the single monitorable fiscal indicator, partly due to the decision to securitize the KSEB bonds, the annual review did not take place. The next annual review of the LSFGO is expected no later than March 2005 following written communication from the state government to the central Government with anticipation that the central Government will be able to release the Rs500 million incentive tranche in full compliance with the LSFGO for 2003/04.	
20. The State shall take a decision on the recommendations of the 2nd State Finance Commission and necessary orders issued by not later than 31 March 2003.	Loan Agreement, Schedule 5, para. 15	**Fully complied with.** On 7 January 2004, the Council of Ministers approved the first part of the Second State Finance Commission recommendations resulting in an allocation to local self-governments (LSGs) of (i) 3.5% of the state's own tax revenue as a general purpose grant and (ii) 5.5% of the state's own tax revenue as a maintenance grant. Accordingly, Rs5.3 billion has been provided for in the 2004/05 budget for LSGs.	The 3rd State Finance Commission constituted in September 2004 has published its report in November 2005. The recommendations of the commission are under consideration of the Government. The decision to transfer one third of the annual size of the state plan to LSGs recommended by the 2nd State Finance Commission is still pending.
21. The State shall continue to adhere to the 1999 agreement among all States of the Borrower not to grant tax concessions under the Sales Tax or its successor VAT.	Loan Agreement, Schedule 5, para. 16	**Fully complied with.** No indirect tax concessions have been granted by the state government.	Fully complied with. State level VAT law was passed. The Legislative Assembly approved the Kerala Value Added Sales Tax Bill (2002) in February 2003. KG undertook the necessary steps to prepare for implementation of new law by 1 April 2003, including the introduction of tax reforms, systems, publicity campaigns, and training. The State switched over to the VAT system with effect from 1 April 2005. Actual VAT collection was lower compared to the average fixed for the state in tune with the collection under Kerala Goods and Services Taxes (KGST) Act. Government of India

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			provided the State with a compensation package of Rs692 crores in 2005-2006. The state is comfortable regarding collection as far as the first 3 months of the current fiscal year is concerned.
Long Pending Infrastructure Projects			
22. The State shall prepare and approve guidelines for termination of infrastructure projects over 5 years old, based on its Policy on Long Pending Infrastructure Projects, by not later than 31 January 2003.	Loan Agreement, Schedule 5, para. 17	**Fully complied with.** The state government has prepared and approved comprehensive guidelines as part of the policy on long pending infrastructure projects and a multi-disciplinary team for inspection has been constituted with the approval of the vice chairperson and State Planning Board, to oversee implementation.	Eleven projects were identified under the initiative – 4 irrigation projects, 5 fishing harbors, and 2 ports – for detailed study. Multi-disciplinary teams were constituted for detailed study about these projects as per the approved policy. Final reports were prepared for 7 projects. Draft reports are ready for 4 projects. These reports were prepared after extensive field visits, public hearing, and review of the available sources of database.
Core Government Functions			
23. The State shall maintain a minimum annual net attrition rate of 1%.	Loan Agreement, Schedule 5, para. 18	**Substantially complied with.** Following the state government's civil service reforms, civil service staff declined by 6% from 526,000 to 493,000 in 2002/03. However, in 2003/04 with the lifting of the ban on recruitment (replacement) in December 2003, the projected civil service staff declined by only 0.6% from 493,000 to 490,000. A total of 25,000 new recruits have been hired to replace retiring staff in 2004 thereby maintaining a 0% net increase. The average annual decline for 2002/03–2004/05 is approximately 2.3%.	11,658 posts identified as surplus, of which, 4,578 staff have been redeployed to LSGs. KG took a decision in December2003 to stop further attrition. There has been no new post creation since 2003.
24. The State shall ensure that there is strict adherence to service guidelines on minimum tenure in a post.	Loan Agreement, Schedule 5, para. 19	**Fully complied with.** There is strict adherence to service guidelines on minimum tenure in a post.	This has not been adhered to and short term turn over have occurred.
25. The State shall approve and notify the Service Delivery Policy by not later than 31 March 2003.	Loan Agreement, Schedule 5, para. 20	**Fully complied with.** The service delivery policy was approved and notified by the state government. The policy was developed through a process of internal and external stakeholder consultations involving government, citizens, civil society, media and business. The policy is operationalized through the 5-year and annual plan development processes of the state government. In addition, the Council of Ministers has approved a Service Delivery Project (SDP), which has facilitated the development and testing of a service delivery improvement methodology.	Service Delivery Policy was notified vide GO (P) No. 260/2004/GAD dated 20 September 2004. Service delivery strategies based on service delivery policy have been finalized in the case of revenue, health, registration, education, food and civil supplies, and social welfare. The strategy is under preparation in the case of LSG and Home Departments. A policy decision was taken to link the implementation of the policy with the

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			implementation of the service delivery improvement plan for identifying the assets for renewal. An Asset Management System for LSGs has been developed and the system will be extended to cover State Government Assets.
26. The State shall approve and notify the Social Audit Policy including the program for first annual implementation of the said policy by not later than 31 December 2002.	Loan Agreement, Schedule 5, para. 21	**Fully complied with.** The social audit policy was approved and notified by the state government and the first annual implementation plan of the said policy has been incorporated into the SDP.	
Poverty Reduction and Minimum Needs Program			
27. The State shall make available the poverty census and poverty database, as validated by the community to the LSGs, departments, and agencies responsible for providing free or subsidized services to poor people, by not later than 31 December 2003.	Loan Agreement, Schedule 5, para. 22	**Substantially complied with.** The poverty census and poverty database prepared in 1999 has been made available to LSGs and other agencies responsible for providing free or subsidized services to poor people. In 2003, a new census was conducted and the results have been computerized. However, due to public litigation in the Supreme Court, the central Government has requested the state government to defer finalization. The state government has decided to validate it using the network of neighborhood help groups of women below the poverty line under Kudumbashree.	The poverty database is expected to be finalized by December 2006. A study on entitlement index is underway and is expected to be completed by September 2006.
28. The State shall take a decision on the merger of DRDAs with District Panchayats by not later than 30 June 2003.	Loan Agreement, Schedule 5, para. 23	**Fully complied with.** The state government has taken a decision to defer the decision on the merger of the DRDAs with district *panchayats*.	Completed as per GO (MS) 87/2001/LSGD dated 27 March 2001. Government issued orders merging DRDA with District Panchayats. This GO was, later on, kept in abeyance. Now, Government vide GO (MS) 132/2006/LSGD dated 5 June 2006 have lifted the stay and operationalized abolition of DRDAs.
State Level Public Enterprises (SLPEs)			
29. With regard to the Second Tranche conditions under the SLPE reforms under the Policy Matrix, the State shall ensure that all stakeholders including the employees and workers that may be affected by the SLPE reforms are fully consulted in a fair and transparent manner including in accordance with applicable laws and regulations of the Borrower and the State, and their views are duly considered in finalization of: (i) the policies on VRS and the SSN, for the employees as referred to in paragraphs 5(b) and 5(c) respectively, in attachment 2 to Schedule 3 of this Loan Agreement; and (ii) the detailed proposals, for reforms/restructuring for SLPEs, as	Loan Agreement, Schedule 5, para. 24	**Fully complied with.** The stakeholder consultation was done before finalization of social safety net program scheme notified under GO 73/2003/ID issued on 24 June 2003.	SSNP scheme has been notified vide GO (P) N. 73/2003/ID issued on 24 June 2003. Welfare and economic sustainability scheme under SSNP will be evolved through wider debates and consultations to be organized under an initiative of MGP. The employees were consulted and feedback was collected.

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identified by the State.			
30. The State shall prepare detailed proposals for SLPEs identified by it in order dated 26 July 2002 in two stages that shall include: (i) proposal on sale/closure of non-operational SLPEs, by not later than 31 March 2003 and (ii) proposal on reform/restructuring of the remaining SLPEs, by not later than 30 June 2003.	Loan Agreement, Schedule 5, para. 25	**Fully complied with.** The state government has approved 28 SLPEs for reform/restructuring and sale/closure and detailed proposals for these have been prepared.	PERC had forwarded recommendation on restructuring proposals on 44 SLPEs to Government. Out of this, recommendations on 28 SLPEs have been approved by the Government. 12 SLPEs were to be restructured with majority stakes for Government; 10 SLPEs were to be restructured with majority stakes to employees/private sector; and 14 unviable SLPEs were closed down. There has been a reduction in manpower in the units that were to be restructured. A Public Sector Enterprise Reform Committee (PSERC) was stopped in 2005, 3 years after being set up. PSERC recommendations on privatization were not pursued. Advertisement for express of interest (EOI) has been released in case of Keltron Counters Limited, Kerala State Salicylates and Chemicals Ltd, Travancore Plywood Industries Ltd, Astral Watches Ltd, Kerala State Detergents and Chemicals Ltd, and Transformers and Electricals Kerala Ltd. Offers received were below the reserve price and were rejected. 3,099 personnel in 25 SLPEs were offered VRS.
31. The Borrower shall transfer the Counterpart Funds generated under the Loan on normal arrangements for transfer of external assistance to the State and shall treat such Counterpart Funds as an addition to its transfers allocated annually to the State. The State shall make available on a timely basis, the Counterpart Funds required for the Program.	Loan Agreement, Schedule 5, para. 26	Complied with.	Complied with.
32. The State shall use the Counterpart Funds to finance the cost of structural adjustment under the Program. In this regard, the State shall provide budget appropriation/allocation to release necessary funds as required for the Program including inter alia for the implementation of: (i) its Asset Renewal Policy, Service Delivery Policy and Capacity Building and Training in Financial Management for LSGs and	Loan Agreement, Schedule 5, para. 27	State is still continuing with these commitments.	Substantial budgetary allocations have been provided for the major activities listed in the condition, except for functional review, for which only a token provision has been provided. LSG Action Plan was approved as per GO (MS) 189/2002/LSGD dated 12 November 2002 and the implementation is underway. Capacity building and

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Community Organizations; and for (ii) support of MGP's administrative and program management expenses, including Service Delivery Policy Unit, functional review unit and the costs associated with the coordination of the implementation of the detailed implementation plans of the SIPs.			training in financial management of LSGs as per the new accounting system prescribed by the Accountant General has been completed. These initiatives continue to be implemented.
33. The State shall set up a PPMS, as agreed with ADB, by not later than January 2003 and cause it to be operated throughout the Program implementation. Under the PPMS, the State shall also undertake periodic review of the Program drawing on the Performance Management Systems Guidelines of ADB to assess and evaluate the scope, implementation arrangements, benefit monitoring, progress, and achievement of the Program.	Loan Agreement, Schedule 5, para. 28		A PPMS-I has been designed for monitoring the progress of general initiatives and a PPMS-II has been designed for monitoring the implementation of the service delivery plans of the institutions selected under SDP.
34. The State shall make available the PPMS reports to ADB and GON on a quarterly basis within 2 weeks after the respective quarter. In addition, the State shall also provide ADB and GON with its Borrower's monitoring and evaluation reports relating to the fiscal reform measures under the Letter of Shared Fiscal Goals and Objectives (LSFGO), the Tripartite Agreement, and the MOU. The State, ADB, and GON shall carry out periodic reviews of the Program, after each report and a final review after the conclusion of the Program.	Loan Agreement, Schedule 5, para. 29		Report for 2005-2006 is being finalized.
Program Monitoring and Review			
35. Without limiting the generality of Section 2.05 (c) of the Program Agreement, the State, ADB, and GON shall closely monitor the implementation of the Program and its impact. In this regard, the State shall provide all relevant information and extend all cooperation that ADB and GON may require for this purpose. The monitoring shall include among other things, the MGP, the tracking of the overall reduction in the fiscal deficit, and adherence to the agreements by the State with the Borrower on fiscal and power sector reforms.	Loan Agreement, Schedule 5, para. 30		KG closely monitors the implementation of the program. Review meetings are held regularly by KG with the initiative owners. ADB reviews the program at the time of missions.
36. The Borrower, the State, ADB, and GON shall undertake a midterm review of the Program at end 2003/early 2004. The mid-term review shall (i) review the scope, design, and implementation arrangements of the Program; (ii) identify changes	Loan Agreement, Schedule 5, para. 31 (a)		The mid-term review (tripartite) was undertaken in September 2003.

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needed since the time of the Program appraisal; (iii) assess implementation performance against Program performance indicators and objectives; (iv) review and establish compliance with the legal covenants; (v) identify problems and constraints; and (vi) the MGP.			
37. In case of any changes required in Program implementation as may be assessed during the mid-term review, the Borrower, the State, ADB, and GON shall mutually agree on appropriate measures including changes in implementation arrangements to ensure that obligations under the Program are met.	Loan Agreement, Schedule 5, para. 31 (b)		Not applicable.
Cofinancing			
38. The Borrower shall transfer the Cofinancing amount to the State on a timely basis for the implementation of the Program. The State shall ensure the application of the same towards implementation of the Program in accordance with the provisions of this Loan Agreement and the Program Agreement.	Loan Agreement, Schedule 5, para. 32	Complied with.	Complied with.
B. Loan Covenants from the Program Agreement			
1. The State shall carry out the Program with due diligence and efficiency and in conformity with sound public management, administrative, financial, engineering, and environmental practices.	Program Agreement, Article II, Section 2.01, (a)	The State Government has carried out the program with due diligence and efficiency and in conformity with sound public management, administrative, financial, engineering and environmental practices and has performed the obligations under the Loan Agreement.	Complied with.
2. In the carrying out the Program and operation of the Program facilities, the State shall perform all obligations set forth in the Loan Agreement to the extent that they are applicable to the State.	Program Agreement, Article II, Section 2.01, (b)	Fully complied with.	Complied with.
3. The State shall make available, promptly as needed, the funds, facilities, services and other resources which are required, in addition to the proceeds of the Loan, in carrying out the Program.	Program Agreement, Article II, Section 2.02	Adequate funds have been provided in the budget.	Adequate funds have been provided in the budget.
4. The State shall carry out the Program in accordance with plans and programs formulated in accordance with public management best practices. The State shall furnish, or cause to be furnished, to	Program Agreement, Article II, Section 2.03	Program has been carried out in accordance with plans and programs formulated in accordance with best programs. Necessary plans, programs have been furnished on request.	Complied with.

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ADB and GON, promptly after their preparation, such plans, programs, techniques and methods, and any material modifications subsequently made therein, in such detail as ADB shall reasonably request.			
5. The State shall maintain, or cause to be maintained, records and accounts adequate to identify the use of Counterpart Funds, to record the progress of the Program (including the cost thereof) and to reflect, in accordance with consistently maintained sound accounting principles, its operations and financial condition.	Program Agreement, Article II, Section 2.04	Records and Accounts being maintained as per standard practice in KG and the Accountants have been audited and reconciled by Accountant General for the years 2002–2003, and 2003–2004.	Accounts reconciled by Accountant General for 2002–2003, 2003–2004, and 2004–2005. Accounts have been kept up to date and reconciled.
6. ADB, the State and GON shall cooperate fully to ensure that the purposes of the Loan will be accomplished.	Program Agreement, Article II, Section 2.05 (a)	The above conditions on program implementation have been variously complied with wherever relevant.	Complied with.
7. The State shall promptly inform ADB and GON of any condition which interferes with, or threatens to interfere with, the progress of the Program, the performance of its obligations under the Loan Agreement, and this Program Agreement, respectively, or the accomplishment of the purposes of the Loan.	Program Agreement, Article II, Section 2.05 (b)	The above conditions on program implementation have been variously complied with wherever relevant.	Complied with.
8. ADB, the State, and GON shall from time to time, at the request of either party, exchange views through their representatives with regard to any matters relating to the Program and the Loan.	Program Agreement, Article II, Section 2.05 (c)	Complied with.	Complied with.
9. The State shall furnish to ADB all such reports and information as ADB shall reasonably request concerning (i) the Loan and the Counterpart Funds; (ii) the expenditures financed out of Counterpart Funds; (iii) the Program; (iv) the administration, operation, and financial condition of the State to the extent relevant to the Program; and (v) any other matters relating to the purposes of the Loan and the Program.	Program Agreement, Article II, Section 2.06 (a)	All reports requested so far have been furnished. These include various documents like Budget Estimates, Medium Term Fiscal Framework, Quarterly Reports published in website and Report on Project Administration. Item nos. 9, 10, and 11 are being complied with.	Complied with.
10. Without limiting the generality of the foregoing, the State shall furnish to ADB and GON, semi-annually reports on the State's budgetary position and its medium-term projections, and quarterly reports on implementation of the Program	Program Agreement, Article II, Section 2.06 (b)	Complied with.	Not applicable.

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during the Program period. Such reports shall be submitted in such form and in such detail and within such a period as ADB shall reasonably request, and shall indicate, among other things, a plan of implementation, progress achieved to date, problems encountered during the quarter under review, steps taken or proposed to be taken to remedy these problems, status and progress of expenditures to be financed out of the Counterpart Funds, and proposed program of activities and expected progress during the following quarter.			
11. Promptly, after closing date for withdrawals from the Loan Account but in any event not later than 3 months thereafter or such later date as ADB may agree for this purpose, the State shall prepare and furnish to ADB and GON a report, in such form and in such detail as ADB shall reasonably request, on the execution and initial operation of the Program, including its cost, the performance by the State of its obligations under the Loan Agreement, and this Program Agreement, respectively, and the accomplishment of the purposes of the Loan, including a comprehensive description of the impact of the reforms implemented under the Program.	Program Agreement, Article II, Section 2.06 (c)		The different items of MGP are included in the State Budget for 2006–2007 and as such the implementation of the program has been sanctioned until 31 March 2007. After the completion of MGP phase I, a comprehensive report on MGP will be prepared and submitted after 31 March 2007.
12. The State shall (i) maintain separate accounts for the Program and for its overall operations; (ii) have such accounts and related financial statements (including separate budget heads of accounts for each of the items of expenditure under the Program, statement of income and expenses, and related statements) audited annually, in accordance with appropriate auditing standards consistently applied, by independent auditors whose qualifications, experience and terms of reference are acceptable to ADB; and (iii) furnish to ADB, promptly after their preparation but in any event not later than nine (9) months after the close of the fiscal year to which they relate, certified copies of such audited accounts and financial statements and the report of the auditors relating thereto (including the auditors' opinion on the use of the Loan proceeds and compliance with the covenants of the Loan Agreement, all in the English language. The state shall furnish to ADB such further information concerning such accounts and financial statements and the audit thereof as ADB shall, from time to time,	Program Agreement, Article II, Section 2.07 (a)	Head accounts are being maintained as per existing practice. Accounts being audited by C & AG.	Head of account's statement of expenditure already furnished. Accountant General (Audit) is the constitutional authority for audit of state accounts. Final figures of A.G. for 2005–2006 will be ready by August end/early October 2006.

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reasonably request.			
13. The State shall enable ADB, upon ADB's request, to discuss the State's financial statements and its financial affairs from time to time with the State's auditors and shall facilitate any representative of such auditors to participate in any such discussion requested by ADB provided that any such discussion shall be conducted only in the presence of an authorized officer of the State unless the State shall otherwise agree.	Program Agreement, Article II, Section 2.07 (b)	Complied with.	Complied with.
14. The State shall enable ADB's representatives to inspect the Program and the relevant records and documents relating to the Program or pertaining to the use of the proceeds of the Counterpart Funds.	Program Agreement, Article II, Section 2.08	Inspections have been enabled during Missions.	Relevant records and documents relating to the program, whichever asked for, have been shared.
15. The State shall, promptly as required, take all necessary actions within its power to implement and carry out the Program.	Program Agreement, Article II, Section 2.09 (a)	Conditions in items 15 and 16 are being complied with strictly.	Complied with.
16. The State shall at all times conduct its business in accordance with sound public management, administrative, and financial practices, and under the supervision of competent and experienced management and personnel.	Program Agreement, Article II, Section 2.09 (b)	Conditions in items 15 and 16 are being strictly complied with.	Complied with.
17. Except as ADB may otherwise agree, the State shall apply the proceeds of the Counterpart Funds to the financing of expenditures on the Program in accordance with the provisions of the Loan Agreement and this Program Agreement and shall ensure that all expenditures financed out of such Counterpart Funds are incurred exclusively in the carrying out of the Program.	Program Agreement, Article II, Section 2.10	Proceeds of counterpart funds are used for the program as stipulated above.	The proceeds of the counterpart funds are applied strictly in accordance with Program and Loan agreements.
18. The State shall promptly notify ADB of any proposal that seeks to alter its status under the Constitution of India.	Program Agreement, Article II, Section 2.11	Not applicable.	No such event requiring such notification has arisen.

ADB=Asian Development Bank, DRDA=District Rural Development Agency, FY=fiscal year, GO=Government Order, GON=Government of Netherlands, GOK=Government of Kerala, KSEB=Kerala State Electricity Board, KSERC= Kerala State Electricity Regulatory Commission, KGST=Kerala Goods and Services Taxes, , LSFGO=Letter of Shared Fiscal Goals and Objectives, LSG=local self-government, LSGD=Local Self-Government Department, MGP=modernizing government program, MGPSC= Modernizing Government Program Steering Committee, PERC=public expenditure review committee, PPMS=project/program performance management system, SIP= Strategic Implementation Plans,