

TECHNICAL ASSISTANCE COMPLETION REPORT

Division: SAGF

TA 3576-IND: Supporting Fiscal Reforms in Kerala			Amount Approved: \$1,000,000.		Revised amount: Same				
Executing Agency: Finance Department		Source of Funding: TASF		TA Amount Undisbursed \$283,591		TA Amount Utilized \$716,409			
Date			Completion Date						
Approval		Signing		Fielding of Consultants		Original		Revised	
13 December 2000		25 May 2001		5 September 2001		30 August 2001		May 2003	
Description									
<p>1. At the time of TA approval, the Government of the state of Kerala (GOK) was facing mounting fiscal pressures. This reflected a combination of a large salary increase for state civil servants following wage increases at the national level resulting from the 5th Pay Commission, sizable cutbacks in central Government transfers, and weakening revenue effort at the state level. By 1999/2000 the fiscal deficit had increased to 7.5% of gross state domestic product (GSDP) and the state's debt had reached 39% of GSDP. The deteriorating fiscal outlook was critically affecting the economy of the state of Kerala. In particular, the Kerala Development Model was showing signs of stress with a combination of high interest rates eroding investment and growth and limited government revenues and mounting debt service payments increasingly threatening achievements in social development. Against this backdrop, GOK sought TA from the ADB to strengthen public finances and to augment the capabilities of the local bodies to assume greater responsibility for social expenditures with a view to ensuring sustainability of spending on economic and social services.</p>									
Objective and Scope									
<p>2. The main objective of the TA was to design effective measures needed to improve the state's public finances and build the necessary capacity for effective implementation. This objective would be supported by adopting a comprehensive four-pronged approach. First, the TA would assist the state government to formulate tax and non-tax reform measures to enhance the GOK's revenue raising capacity. Second, the TA would upgrade the institutional capacity of the state's Finance Department to manage and control public spending and introduce greater accountability and transparency in budget making. Third, the TA would prepare a consensus-based legal and administrative framework to promote fiscal responsibility to ensure the sustainability of public finances. Finally, the TA would strengthen the capabilities of local bodies to assume greater responsibility for social spending and make their functioning more transparent and accountable.</p>									
<p>3. The TA would help to develop: (i) a detailed plan to introduce value added tax (VAT) in Kerala; (ii) propose measures to strengthen the capacity of the non-tax revenue cell in the Finance Department to levy adequate user charges on social services; (iii) identify the institutional requirements for promoting fiscal responsibility, introducing multiyear budgeting, and promoting greater output linked accountability in budget formulation and implementation for the state government and local bodies; (iv) prepare a legal and administrative framework to implement fiscal responsibility to ensure the sustainability of public finances; (v) develop a simple, transparent, and accountable expenditure monitoring and control system based on information technology for local bodies; (vi) prepare an action plan to transfer health care facilities and water supply schemes to local bodies in a phased manner; (vii) review the tax structure and revenue buoyancy of stamp duty and registration fees, motor vehicle taxes, state excise duty, and other minor taxes, and recommend improvements as appropriate; and (viii) examine Kerala's expenditure priorities in key social sectors against changes in the socioeconomic environment and recommend suitable changes.</p>									
Evaluation of Inputs									
<p>4. The TA paper was clearly formulated including a sound rationale for ADB assistance and a detailed breakdown of supporting inputs in order to accomplish the intended objectives. TA inputs comprised 79 person-months of consultancy services with the ADB financing 21 person-months of international and 42 person-months of domestic consultancy services and the GOK financing 16 person-months of domestic consultancy services. Outline terms of reference for the consulting services inputs were clear and their respective activities were linked to attendant activities, outputs and goals.</p>									
<p>5. Overall, there were three contract variations. In November 2001, TA resources were reassigned to reflect the GOK request to strengthen the area of budgeting and expenditure management. To accommodate this change the consultant on local government accounting and financial management systems was dropped and the assignment of the consultant on utilities pricing was reduced. Another contract variation reflected the Government of India's (GOI) decision to defer the introduction of VAT nationwide to 2003 (subsequently further deferred). This together with a coincidental government employees strike led to a reorientation of the VAT consultant's activities from design of VAT systems and procedures towards a greater focus on VAT training. Finally in January 2002, there was a significant refocus of the TA towards support for the Modernizing Government Program (MGP) initiatives. This change led to the reallocation of resources away from their intended objectives although it was justified on the grounds that it would reinforce institutional structures and focus on more efficient delivery of government public goods and services. In particular, the GOK and the project manager were of the view of the need to build internal mechanisms in the various departments to ensure greater ownership and management of the change process underlying the proposed reforms.</p>									
<p>6. The TA was approved in December 2000 and signed in May 2001. Consultants were fielded in September 2001. An inception report was prepared in November 2001 and a mid-term report in March 2002. A strategic planning workshop was held in April 2002. A tripartite meeting was held in June 2002 to present the draft final report, comprising 16 volumes. The final report was submitted in September 2002. A State Public Finance Reform Committee was created to oversee implementation of the TA and chaired by the Vice Chairman of the State Planning Board. In addition, an MGP Secretariat was created, which did provide significant support to developing the MGP initiatives. The EA's support to the TA was satisfactory. Office space, transportation, communication, and equipment provided were adequate. However, there was an unfortunate incident during the government employees strike, which resulted in the attack and vandalizing of the project offices. This incident could have been avoided through stronger and more active government communication policy outlining the importance and long-term benefits of the reforms. Indeed relations with the Government while very supportive on the MGP initiative could have been stronger in the area of fiscal management especially following the change in Government. The project was satisfactorily administered and monitored by ADB. The ADB review missions concluded that the key objectives of the revised TA were adequately met.</p>									

Evaluation of Outputs

7. The TA identified seven major output components including three directly related to revenue generating measures through tax and non-tax measures, three on expenditure management and control and one on the fiscal framework. The inputs identified in the TA are generally consistent with the expected output although revealing a slight inclination towards the expenditure management component with 12 of the 21 person-months of international consultants responsible for this component. The TA made specific recommendations across various activities including: designing a fiscal reform program, designing results and performance in the public sector, budget preparation and planning, VAT implementation, other revenue augmentation measures focusing on minor tax and non-tax schemes and an overview of checks on expenditure management on health, water and general utilities. As mentioned above, the VAT component was refocused towards capacity building. Six workshops and seminars were organized on VAT basic concepts, self-assessment and taxpayer audit. In addition, a 1-week training module was conducted on VAT implementation. The MGP framework comprised five components, which have to date planned a total of 93 separate initiatives. 28% of total TA funds went un-disbursed. This reflects two factors, namely underutilization of committed resources for: (i) the VAT component due to the Government's decision to defer its implementation; and (ii) developing a fiscal program due to the reassignment of this activity to the Government and ADB staff. Under a more predictable environment, TA resources could have been fully utilized.

8. A review of the final report points to a comprehensive assessment of fiscal management constraints in Kerala. However, many of the recommendations and supporting analysis tended to be of a generic and broad nature. Indeed, according to the final report, "[i]t needs to be recognized that although the Project provides advice on possible actions that could be taken in the near-term, its main contribution will be in *indicating the possible directions for changes* in different areas." This in turn leads to a more fundamental concern which is the need to bear in mind that reforms to public finances reflect the successful pursuit of structural change involving changes in management practices. These practices are often deeply rooted in the bureaucracy and hence the need for TAs to pay particular attention to systems and procedures underlying these practices. As the final report emphasizes, in this instance with reference to performance budgeting, "[t]heir impact is likely to be slight in an environment *totally lacking incentives* for good/bad performance by public service managers." It is likely that reference to incentives constraint applies more generally to the entire process of fiscal management. Accordingly, as the report states, "[i]t should be stressed that full implementation of these changes, if adopted by GOK, would take a number of years to complete."

9. The refocusing towards MGP initiatives has been an example of project flexibility and reflects an attempt to address the concern for sustainability of reforms. Indeed as the final report points out, "the inclusion of a component to support the MGP is thus an essential part of the overall implementation strategy of this project." In particular, it may prove a critical output to ensure that GOK can "continuously design, manage and monitor the change process throughout the administration." However, as a note of caution, the MGP initiatives need to weave a fine line to ensure sustainability of results without alienating the rest of the bureaucracy and avoid the problem of competing enclaves. Sustainability of reforms in the state of Kerala will ultimately depend on the extent that MGP is successfully able to design and implement an incentives and results-based approach to institutional reform, which ultimately may serve as a model for government.

Overall Assessment and Rating

10. The overall assessment of the TA can be rated as successful. Among the achievements, TA recommendations were reflected in the preparation of the 2002-2003 Kerala State Budget, the Tenth State Plan and the Fiscal Responsibility Act. In addition, an MGP secretariat was established to support Government reforms from within the public administration. The TA implementation went through some setbacks reflecting varying perceptions of Government ownership of the reforms, however the TA was, in turn, amended to better address these weaknesses. While the overall rating is successful, there were differences in the degree of success with the MGP initiatives overshadowing achievements in core fiscal management. Follow-up actions were identified in the TA report and include restructuring the Department of Finance, restructuring public debt management and overhauling the state procurement system. In addition, the last of the four goals referred to in paragraph 2, above, did not take place. To summarize, on the positive side, many of the TA recommendations were sound and accepted by the Finance Department. However, on the negative side, the State Public Finance Reform Committee was never convened to assess/endorse the final TA recommendations.

Major Lessons Learned

11. The major lessons learned from processing and implementing the TA include the importance of: (i) preparatory work; (ii) flexibility in the scope of the TA; and (iii) recognizing the limits of what a single TA may achieve, particularly in areas of integrated institutional reform. The success of the TA is attributable to adapting the TA to a more realistic set of goals given the backdrop of a highly politicized state that was still debating the benefits of structural reforms. Indeed the ADB should ensure strong prior Government commitment to reforms especially in view of the potential adjustment costs associated to public sector reforms. In addition, Government commitments need to be backed by a communication policy that is able to credibly convince all stakeholders on the benefit of the reforms supported under the TA. It is also important for the ADB to recognize that cluster TAs may be required in support of systemic reforms against the backdrop of significant institutional constraints, characterized by a deeply ingrained culture that is resistant to change. These problems are often magnified when dealing across different levels of government as was the case with this TA. Finally, to ensure sustainability of reforms there is a need to revise the incentives mechanisms from within in order to foster greater ownership and facilitate achieving the intended goals.

Recommendations and Follow-Up Actions

12. The TA final report has made various recommendations as well as identified areas for further TA. As a matter of priority, these should be followed up by the on-going TA supporting the MGP under the Modernizing Government and Fiscal Reform Program (MGFRP). In particular, two areas needing TA support include overhauling of the state procurement system for the purpose of increasing cost effectiveness and restructuring debt including the introduction of an efficient debt management and monitoring system to generate further fiscal savings. In addition, the pending component under the reviewed TA, namely capacity building for local government for social spending should be supported under the on-going TA. Close and continuous coordination with the GOK, the GOI and local Government in the context of MGFRP will be essential to ensure full implementation of reforms including revisiting those recommendations that were never assessed with the objective of ensuring Government endorsement and implementation.