4. Reform scenarios: fiscal prospects

BASELINE SCENARIO

The baseline scenario has been constructed to show the fiscal path of the State in the absence of any corrective action on either expenditure or revenue fronts. The baseline scenario represents our best judgement of future expenditures and revenue collections. Departures if any from the declared intentions of the government are justified (see *Policy towards PSUs,* chapter 3).

Projected GSDP growth rates: Nominal GSDP is projected to grow at an annual rate of 13 percent over the five years 1997-2002,[1] of which the inflation component is 7 percent as notionally projected for the Ninth-Five-Year-Plan (1997-2002), as also for the State Ninth Plan. This is broadly consistent with the inflation experience in Punjab relative to the national rate over 1980-96 (see appendix A). In conjunction with 13 percent nominal growth, that implies a real growth rate of 5.6 percent per annum. This is a little higher than the growth rate of 5.06 percent targeted by the draft Ninth Plan for Punjab but well below the targeted national rate of 7 percent. Given the average growth rate of 5 percent achieved over the last fifteen years (table 1.1), a projected growth rate at 5.6 percent for 1997-2002, even though lower than the national target, borders on the optimistic. It must be remembered, however, that growth in Punjab in the last ten years has been disrupted by terrorism, and that with the restoration of law and order, the stage is set for a growth spurt, if backed by supportive public policy.

All State-level GSDP figures are available only at factor cost. Deficits and other magnitudes as percentages of these figures will be higher than, and therefore, not directly comparable to the Central government deficit which is expressed as a percentage of the market price aggregate.

The procedure: Because permissible net borrowing is an outcome of bilateral negotiations between the state and centre (see *Fiscal deficit;* and *Total expenditure,* chapter 2), the GFD cannot be obtained as a residual after independent projections of revenues and expenditures. The GFD is defined by the approved rates of increase for

1 The 13 percent nominal growth rate is used also to estimate the GSDP for 1996/97 in the absence of official estimates for that year.

components of new borrowing for the Ninth Plan (1997-2002) period (table F.4).[2] Since these rates of increase are lower than the growth rate of nominal GSDP assumed here, the debt stock shows a fall as a percent of GSDP. The GFD as projected here at approved rates of new borrowing shows a steady fall as a percent of GSDP to a terminal value of 3.20 percent for 2001/02 (table F.1; see also *Projected GSDP growth rates* above).

Debt dynamics: Because GFD/GSDP is exogenously prescribed, the dynamics of debt lives independently of the process of fiscal accommodation, and is the same across baseline and all reform scenarios. The debt write-offs scheduled for the period 1997-2000 have been factored into the projections.

Total revenue: The exogeneity of GFD means that total expenditure is subjected to accommodation within what the negotiated GFD/GSDP and the revenue effort together make possible. Revenue projections thus critically underpin the whole exercise. Total revenue as projected here rises from 10.60 percent in 1997/98 to 10.99 percent in 1998/99 and 10.66 percent thereafter, essentially because of the growth in shared taxes from the Centre. This in turn results from application of the alternative devolution formula for States' share starting 1998/99 (see appendices F and G), and for 1998/99 alone the additional devolution from the VDIS scheme of 1997/98. Own tax revenue (gross), projected at the historical buoyancy coefficient of 0.98, remains at a constant ratio to GSDP, but there is a mild drop in net revenue after the deduction of revenue assigned to local bodies. There is a drop in own non-tax revenues resulting from use of the historical buoyancy coefficient of 0.68. Table F.1 also provides the budget estimates of revenue for 1997/98, so as to provide a check on the projected figures. Budget estimates are not always reliable, however (see *Lack of transparency,* chapter 2; and note 1 to table F.1).

Recent revenue giveaways: Of the four 1997 giveaways (free water and electricity for farmers; abolition of land revenue and property taxes) only free water has a revenue impact (see *Fiscal giveaways,* chapter 2); as pointed out there, the revenue impact of these measures does not adequately measure their damage.

Expenditure components: After the projection of total expenditure obtained from the sum of projected revenue and GFD, each component was projected by economic rather than functional classification, starting with interest payments, the least discretionary,

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2 In case of market borrowings, if an issue is over-subscribed, as does indeed happen with Punjab, actual borrowings might exceed the negotiated amount. An alternative route not adopted here is to project the GFD at its observed average as a per cent of GSDP. The average value of 4.82 per cent over the period 1980-96 was exceeded several years in the mid-eighties (chart 2.1), owing to exceptional circumstances, but in recent years it has stabilised at this level (table 2.1).

proceeding to pensions and wages/salaries, and downward in ascending order of amenability to compression. The last component, capital outlay, is residually determined and thus bears the brunt of fiscal adjustment. This is in line with the revealed decline in capital outlay in the State (see *Economic classification,* chapter 2).

Interest: The marginal (nominal) rate on gross incremental debt is assumed at 13.25 percent. This raises the average (nominal) interest rate on debt rises from 11.23 percent in 1996/97 to 12.86 percent in the terminal year. The method of calculation is explained in detail in appendix F. The interest projections, like the progression of debt stock (see *Debt dynamics* above), do not vary between scenarios because of the exogeneity of GFD/GSDP. The interest write-off on loans from the centre (see *Loan waivers,* chapter 2) suppresses interest payments upto 1999/2000. Beyond that, interest payments rise to a terminal value of 3.58 percent of GSDP.

Non-interest components of expenditure: Because of the particular recent history of Punjab State, whereby expenditures from the mid-eighties until about 1993 are known to have been distorted in both quantum and composition by the fight against terrorism (see *Introduction*; and *Sectoral performance,* chapter 1), projecting expenditure based on trends in the previous decade was not an available option. Therefore the baseline scenario projects economic components of expenditure by the ratios to GSDP that prevailed during the three years 1994-97 immediately preceding the projection period, except for wages and salaries (see *Wages and salaries,* chapter 4). An economic breakdown was fortunately available for all three years, but only of the R.E. for 1995/96 and B.E. for 1996/97. In the case of three components of expenditure which carry some element of discretionarity, the projected percent of GSDP is at or in some cases a little below the lowest value observed in the base period, so as to incorporate in the baseline scenario the stated intentions of the State government to contain infructuous expenditures (see earlier para, *Loans and advances* below; and appendix F).

Expenditure smoothing: Expenditure to GSDP averages by economic category for 1994-97 were obtained after elimination of assorted expenditure spikes; adjustments to the raw data are detailed in appendix D.

Adjustment to budget expenditure aggregates: Total expenditure aggregated across economic categories is always systematically lower than those from Budget documents, because the economic classification nets out intra-government flows (see table 2.3). Since the Budget documents are the only source of information on non-tax (as indeed all other) revenue, the budget total for expenditure had necessarily to be retained for compatibility with the revenue figures. The manner of adjustment of the economic components of expenditure to the budget aggregate is detailed in appendix F.

Plan/non-Plan classification: Expenditure has not been broken down in any of the scenarios by Plan/non-Plan classification, because this deflects away attention from the more important breakdown of expenditure by economic classification. For example, Plan expenditure becomes a conventional escape valve through which government staff can be increased (see *Wages and salaries* below/). The general approach of regarding non-Plan expenditure as deserving of curtailment and Plan schemes as not has led among other things to a squeeze on maintenance, a non-Plan expenditure.

Wages and salaries: Wages and salaries, at 4.5 percent of GSDP on average in the base period constitute the single largest component of expenditure, exceeding even interest payments. The stated policy of the government on staff size is a freeze on recruitment. However, recruitment of staff under new Plan schemes falls outside the purview of this freeze, and functions as an escape valve; there is no internal redeployment of existing staff to the new posts created. The budgetary exercises of the Ministry of Finance provide for an annual 10 percent increase in the wage/salary bill, but the figures show that at least in 1995/96 (R.E.) the wage/salary bill rose by 18.4 percent relative to the previous year. The next year's budget estimate shows only a 0.14 percent increase, but in the absence of the RE economic breakdown for that year, it is not known if the budgeted containment was in fact achieved. This is a category where there is a wide gap between budgetary intentions and actuals. There was however no justifiable alternative to projecting an annual increase of 10 percent, starting from 1996/97 (B.E). This projection is on account of staff expansion and inflation indexation alone, independently of real wage increases, which occur only discretely with the implementation of the scales recommended by successive Pay Commissions. So projected, the salary bill for 1997/98 pre-Pay Commission amounts to Rs. 2035, a little above the Ministry of Finance figure of Rs. 2000 (see *Pay Commission impact,* chapter 2).

The Pay commission impact: To the base wage/salary projections must be added the additional expenditure on account of the real wage increases of the Fifth Pay Commission, payable starting January 1998 in amounts shown in *Pay Commission impact,* chapter 2. The impact of the Pay Commission on pensions has not been worked in; the effect will show only beyond the projection horizon of this exercise.

Loans and advances: The stated government policy of an absolute reduction of loans to PSUs by 10 percent a year is so implausible in the face of the immediate impact on PSUs of the Pay Commission increases, that it cannot go into the baseline scenario. Net loans and advances in the base period show a steep rise from a starting value of 0.97 percent in 1994/95 to 1.93 percent in 1995/96 (R.E.). The reduction in the next year is not necessarily evidence of fiscal correction. Loans and advances can be deferred in the short-run, but not indefinitely in the absence of PSU reform. This does however offer one avenue for containment in the expenditure compression scenario, **if accompanied by PSU reform.**

The baseline fiscal squeeze: Capital outlay shows no reduction in the first three years entirely because of the substantial interest write-off (see *Loan waivers*, chapter 2; and table F.1). Within these three years the squeeze further loosens in 1998/99 because of the sharp rise that year in central tax shares (see *Total revenue* above). In subsequent years, there is a further reprieve on account of the decline in percentage share of wages and salaries after the initial Pay Commission impact. Despite this, the terminal year capital outlay reduces to a mere 0.25 percent of GSDP.

Revenue deficit: The negotiated GFD and the residual character of expenditure on capital outlay together imply that the revenue deficit (RD) rather than the GFD must be looked to as an indicator of fiscal health at State level (see *Fiscal deficit*, chapter 2). The RD shows some decline in the first three projection years on account of the interest write-offs, but rises thereafter to a terminal value of 1.75 percent of GSDP.

Key fiscal variables in baseline scenario: Table 4.1 summarises the baseline scenario in terms of three key projected variables, and two outcomes:

i. Total revenue receipts
ii. Wages and salaries
iii. Net loans and advances
iv. Capital outlay
v. Revenue deficit

Reform scenario #1 attempts fiscal correction in respect of each of the first three. The impact shows in capital outlay and the revenue deficit.

REFORM SCENARIO #1

Revenue enhancement: Given the exogenously specified cap on permissible borrowing, a release from the total expenditure constraint is possible in the first instance only if revenues are enhanced. Possible avenues of revenue enhancement were explored through discussions with the relevant State government officials and quantified in terms of feasible absolute increments. The alternative for tax revenues of injecting into the reform scenario higher than historical buoyancy coefficients is a mechanical exercise unless it carries formal justification. For non-tax revenues, on the other hand, there is a formal alternative. Non-tax revenues can be derived from current expenditure projections broken down by functional sector, assuming an implicit rate of subsidy in each (see *Subsidies: explicit and implicit*, chapter 2). Rates of implicit subsidy by sector are available for 1993/94 (Srivastava et.al. 1997). Since baseline expenditures were with a few exceptions projected at the GSDP growth rate, use of a constant set of implicit subsidy rates with

Table 4.1: Annual Impact of Reforms on Key Fiscal Variables

(Percent of GSDP)

	96/97 (B.E.)	97/98 (P)	98/99 (P)	99/2000 (P)	2001/01 (P)	2001/02 (P)
Baseline						
Revenue Receipts	10.87	10.60	10.99	10.67	10.66	10.66
Wages and salaries	4.25	5.42	5.24	4.75	4.62	4.50
Net loans and advances	1.47	1.20	1.20	1.20	1.20	1.20
Capital outlay	1.08	0.37	0.91	0.88	0.16	0.25
Revenue deficit	2.04	1.82	1.23	1.21	1.88	1.75
Reform scenario #1						
Revenue receipts	10.87	11.17	11.55	11.21	11.18	11.16
Wages and salaries	4.25	5.34	5.08	4.51	4.31	4.12
Net loans and advances	1.47	1.02	0.90	0.80	0.70	0.62
Capital outlay	1.08	1.21	2.03	2.24	1.75	2.02
Revenue deficit	2.04	1.17	0.41	0.25	0.79	0.55
Reform scenario #2						
Revenue receipts	10.87	11.17	11.55	11.21	11.18	11.16
Wages and salaries	4.25	5.37	5.10	4.53	4.33	4.14
Net loans and advances	1.47	1.02	0.90	0.80	0.70	0.62
Capital outlay	1.08	0.60	1.49	1.75	1.30	1.62
Revenue deficit	2.04	1.77	0.95	0.75	1.24	0.95

***Source*:** Tables F1 to F3.

Notes: For reasons explained in appendix F, the projections were based on the B.E. for 1996/97 because the economic classification of the RE for that year was not available.

reference to baseline expenditures essentially implies growth of non-tax revenue at GSDP growth rates, i.e. a buoyancy coefficient of unity, as opposed to the baseline projections of non-tax revenue, which were based on the historical buoyancy coefficient of 0.68. Not surprisingly, the absolute increment in own non-tax revenue projected in accordance with this formula were judged to be totally infeasible by State government officials.

Feasible revenue enhancement: Feasible increments in non-tax and tax revenue are given below. The tax increment is the expected outcome of an October 1997 agreement between eight states in the northern region on floor rates of 15 commodities; commodity-specific details are in section J.1, appendix J. These floor rates are yet to be notified in Punjab. The non-tax increment is aggregated across sector-specific possibilities identified in section J.2, appendix J. The projected figures for 1997/98 are counterfactuals.

(Rs. crore)

	97/98	98/99	99/2000	2000/01	2001/02
Non-tax	250	275	300	325	350
Tax	30	35	40	45	50

Sectoral break-up of enhanced non-tax revenues: The sectoral break-up of the revenue addition in 1997/98 is listed in the synopsis. Of the Rs. 250 crore initial-year increment, Rs.125 crore is from the planned introduction of on-line state lotteries, patterned on the National Lottery of England. The scheme, scheduled for introduction in 1997 with foreign collaboration, was obstructed by the Central Foreign Investment Promotion Board and adverse High Court rulings (see section J.2, appendix J and note 2, table F.1). It would not be too much of an exaggeration to say that lotteries are seen as the future revenue bail-out of the State government. As a result, not enough attention is being paid to user charges from beneficiaries of government services. The attempt in this report at identifying sources of additional revenue from every possible sector, no matter how trivial the amount, is part of an effort to drive home the culture of revenue-consciousness across the entire spectrum of service-provision by government. Some measures along the directions suggested have already been introduced, such as hikes in fees charged for public service examinations. Much remains to be done.

Departmental enterprises: Departmental enterprises are found in sectors where cost-recovery is expected (such as transport) as distinct from sectors where it is not (such as social sectors). Departmental enterprises are not supposed to make losses, let alone of the order of the losses of Punjab Roadways (PR) (see *Transport,* chapter 3; and appendix J). Although the initial additional recovery is only Rs.5 crore (see *Synopsis*), as against an annual loss of Rs.16.73 crore, the objective should be to **wipe out losses completely by 2001/02.** The Rs.25 crore increment in total non-tax revenue each year has not been broken down sectorally, but the first target for eventual full cost recovery should be departmental enterprises.

Expenditure compression: Three expenditure compression initiatives are introduced in reform scenario #1.

i. A staff freeze (zero net addition), starting 1997/98. Growth in wages and salaries is reduced to 8 percent, with 7 percent for inflation indexation, and 1 percent for increments/promotions. The absolute wage hike of the Pay Commission has been phased in identically to the baseline scenario. For details see *Staff freeze* (net) below.

ii. A freeze on net loans and advances at Rs. 500 crore, the BE figure for 1997/98. (For details, see *Loans and advances* below).

iii. A freeze on non-educational grants (45 percent of the total) at Rs. 393.72 crore starting 1997/98; this is the estimated absolute expenditure in 1996/97 B.E. (see table F.1). This includes grants to local bodies but does not touch their share of state taxes.

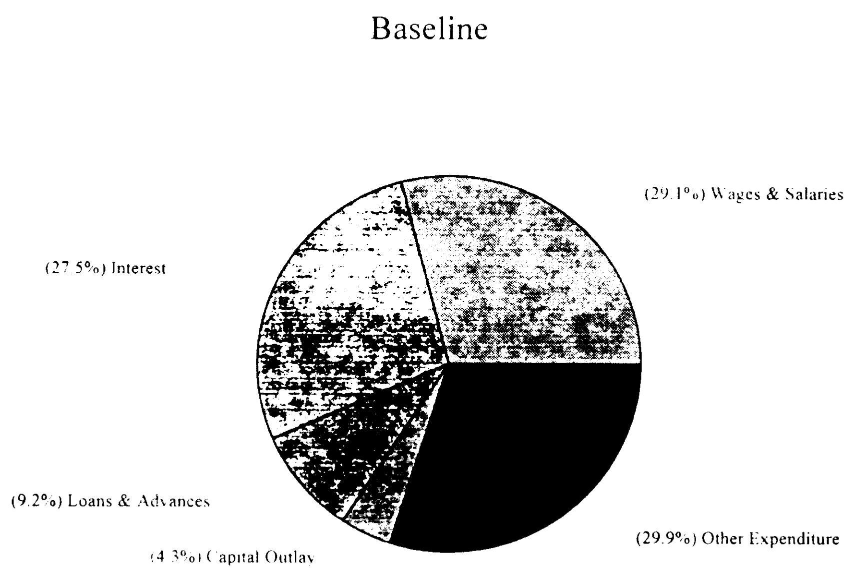
Uncompressed expenditures: Non-discretionary categories like interest and pensions are not amenable to compression. Discretionary payments left uncompressed are:

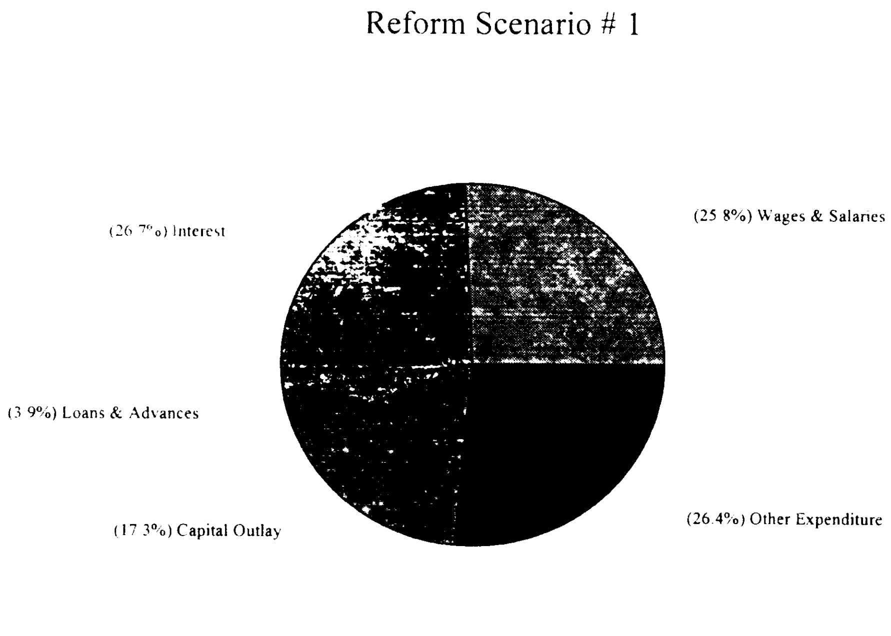
i. <u>Educational grants</u>: (see *Expenditure compression* above(iii). Potential fiscal gain from elimination: 0.99 percent of GSDP. These are committed expenditures to aided educational institutions, impossible to freeze over the five-year horizon when these institutions will be under pressure to raise salaries.

ii. <u>Explicit subsidies:</u> Potential fiscal gain from elimination: 0.35 percent of GSDP. Of the total subsidy bill, industry is the recipient of 46 percent, and agriculture 28 percent (table D.2, appendix D). The industrial subsidies fall in the class of competitive fiscal giveaways which require inter-State coordination for elimination (see section J.2, appendix J). Agricultural subsidies likewise are linked to Central subsidies and will require Central government coordination for elimination.

iii. <u>Other current transfers:</u> Potential fiscal gain from elimination: 0.15 percent of GSDP. Of the total, 46 percent goes to social security and welfare. These are underpinned by equity considerations, not politically amenable even to an absolute freeze, let alone a reduction.

Staff freeze (net): The wages/salary bill is a necessary area of expenditure compression in Punjab. At 4.5 percent of GSDP on average in the immediate pre-projection period 1994/97, it is the highest component of government expenditure (see *Wages and salaries* above). Over the fifteen years to 1995/96 public administration grew at an annual


Baseline
(29.1%) Wages & Salaries
(27.5%) Interest
(9.2%) Loans & Advances
(4.3%) Capital Outlay
(29.9%) Other Expenditure


Reform Scenario # 1
(25.8%) Wages & Salaries
(26.7%) Interest
(3.9%) Loans & Advances
(17.3%) Capital Outlay
(26.4%) Other Expenditure

rate of 6.23 percent (table A.1) as compared to 5.81 percent all-India, with a particularly rapid spurt during the five years 1986-91, when annual growth in public administration rose to 10.63 percent, clearly reflecting the administrative effort to curb terrorism. The inflation rate in public administration, at 9.44 percent annually in the fifteen years to 1995/96, was no higher than the national level (table A.5). The two together show that it is staff growth at higher than national levels that is responsible for the present size of the wage bill, and that this should be a critical feature of fiscal correction. Zero net growth in staff is a far less stringent curtailment than the 3 percent per year downsizing in filled posts recommended by the Fifth Pay Commission, as a condition for the introduction of the revised salary scales.

Loans and advances: This is the single largest area of opportunity for fiscal correction, but is not possible without PSU reform (see *PSUs and the state exchequer,* chapter 2). Net loans/advances amounted in 1995/96 (RE) to 1.87 percent of GSDP, and were projected in the baseline scenario at 1.2 percent of GSDP. The budget estimates for 1997/98 provide Rs. 500 crore for net loans/advances. Net loans are frozen at this fixed absolute sum of Rs. 500 crore. This alone yields by 2001/02 fiscal resources amounting to 0.58 percent of GSDP.

Reform impact on capital outlay and the revenue deficit: Table 4.1 shows that these reforms, which are independent and additive, together push up capital outlay in the terminal year from 0.25 percent in the baseline scenario to 2.02 percent of GSDP. The revenue deficit in the terminal year declines from 1.75 percent in the baseline scenario to 0.55 percent in reform scenario #1.

REFORM SCENARIO #2

Rationale for a Second Reform Scenario: The reforms of scenario #1 enable higher capital outlay, but an alternative use for some of the additional expenditure made possible is higher current expenditure to plug spending gaps in three particularly critical sectors. There has been a historical sacrifice of expenditure on maintenance to fiscal accommodation (see *Capital expenditure,* chapter 2; and *Operation and maintenance,* chapter 3), although even the economic classification categories do not permit a quantification of this suspicion. **The two scenarios separate the suggested reforms by type and imply no necessary time sequencing,** although in general additional fiscal resources will have to be generated by reforms of the type suggested in scenario #1 before the expenditure enhancements of scenario #2.

Plugging spending gaps: Enhanced current expenditures are added on to the expenditures of reform scenario #1 for three sectors: irrigation, roads and primary education. The maintenance gap for the power sector, quantified in appendix H, will have to be a part of a financial restructuring exercise for PSEB, a non-departmental PSU whose expenditures are not included in the State budget (see *Policy towards PSUs*, chapter 3). The same holds for transport where again there is underfunding of maintenance (appendix I). Irrigation and roads are directly administered by the State government.

Maintenance norms: Standard expenditure norms for maintenance of roads and irrigation works have been used to generate the incremental requirement over and above that provided for in reform scenario #1. This exercise is performed in Appendix L. The required increment is included in expenditure on materials alone, since this is the category that bears the burden of fiscal accommodation. The staff required for maintenance are already in place.

Enhanced expenditure on primary education: Staff growth in primary education has in recent years been negative (table E.3). In order to correct for this, the (net) staff freeze of reform scenario #1 is augmented by an annual 3 percent (net) staff addition in primary education alone. There is also a small augmentation of the expenditure provision for teaching materials (appendix L).

Impact on capital outlay and the revenue deficit: Table 4.1 shows that the combined effect of these increases in current expenditure reduces capital outlay in the terminal year by 0.40 percent relative to reform scenario #1. The contribution of each component is shown in appendix L and summarised in the synopsis of proposed reforms. The revenue deficit in the terminal year correspondingly rises to 0.95 percent of GSDP in reform scenario #2 from 0.55 percent in reform scenario #1.