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# Himachal Pradesh

## Accelerating Development and Sustaining Success in a Hill State

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 2007



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Accelerating Development and Sustaining Success in a Hill State



Poverty Reduction and Economic Management  
India Country Management Unit  
South Asia Region



THE WORLD BANK  
2007

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## CURRENCY EQUIVALENTS

(Exchange Rate Effective)

Currency unit	=	Rupees (Rs.)
Rs.1	=	US\$ 0.024486
US\$ 1	=	Rs. 40.84

## FISCAL YEAR

April 1 – March 31

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Sector Director	Sadiq Ahmed, SASPR
Sector Manager	Kapil Kapoor, SASPR
Task Managers	Ananya Basu, SASPR Mohan Nagarajan, SASPR Paramita Dasgupta, SASPR

## Abbreviations and Acronyms

AAJ	Antyodaya Anna Yojana	NOAPS	National Old Age Pension Scheme
MMR	Maternal Mortality Rate	COPD	Chronic Obstructive Pulmonary Disease
AG	Auditor General	O&M	Operations and Maintenance
MoU	Memorandum of Understanding	COPU	Committee on Public Undertakings
ATR	Action Taken Report	OLTIS	On-line Treasury Information System
MTFP	Medium Term Fiscal Projections	CSS	Centrally Sponsored Schemes
BPL	Below Poverty Line	PAC	Public Accounts Committee
NFBS	National Family Benefit Scheme	DDO	Drawing and Disbursal Officers
C&AG	Comptroller and Auditor General of India	PDS	Public Distribution System
NCAER	National Council of Applied Economic Research	DGP	Director General of Police
CAT	Catchment Area Treatment	PEMT	Project E-Mission Team
NPV	Net Present Value	DSCR	Debt Service Coverage Ratio
CHC	Community Health Center	PHC	Primary Health Center
NREG	National Rural Employment Guarantee	ELFA	Examiner Local Fund Audit
CII	Confederation of Indian Industry	PMGSY	Pradhan Mantri Gram Sadak Yojana
NRHM	National Rural Health Mission	FRBM	Fiscal Responsibility and Budget Management
CMR	Child Mortality Rate	PMIS	Personnel Management Information System

## Abbreviations and Acronyms

FRU	First Referral Unit	SHG	Self Help Groups
PPP	Public Private Partnerships	IA	Internal Audit
GDDP	Gross District Domestic Product	SLA	Service Level Agreements
PRI	Panchayati Raj Institution	IAS	Indian Administrative Service
GDP	Gross Domestic Product	SLL	Special Local Laws
PS	Panchayat Samitis	IAY	Indira Awaas Yojna
GFR	General Financial Rules	SPCB	State Pollution Control Board
PSE	Public Sector Enterprises	IMC	Industry Management Committee
GoHP	Government of Himachal Pradesh	T&D	Transmission and Distribution
PSEB	Punjab State Electricity Board	IMR	Infant Mortality Rate
GoI	Government of India	TFC	Twelfth Finance Commission
GP	Gram Panchayat	IPC	Indian Penal Code
PWD	Public Works Department	UC	Utilization Certificate
GSDP	Gross State Domestic Product	IPH	Irrigation and Public Health
RGAY	Rajiv Gandhi Awaas Yojna	ULBs	Urban Local Bodies
HoD	Head of the Department	IRDPA	Integrated Rural Development Programme
RKS	Rogi Kalyan Samitis	VAT	Value Added Tax
HP	Himachal Pradesh	IT	Information Technology
RLB	Rural Local Bodies	VLC	Voucher Level Consolidation
HPERC	Himachal Pradesh State Electricity Regulatory Commission	ITI	Industrial Training Institutes
RTI	Right to Information	VRS	Voluntary Retirement Scheme
HPSEB	Himachal Pradesh State Electricity Board	JNURM	Jawaharlal Nehru Urban Renewal Mission
SEB	State Electricity Boards	WAN	Wide Area Network
HPTDB	HP Tourism Development Board	LMIS	Labor Market Information System
SGSY	Swaranjayanthi Gram Swarozgar Yojana	WPR	Work Participation Rate
HPTDC	HP Tourism Development Corporation	MDG	Millennium Development Goals
SGRY	Sampoorna Grameen Rozgar Yojana	ZP	Zilla Parishads
HRTC	Himachal Road Transport Corporation		

# Team and Acknowledgements

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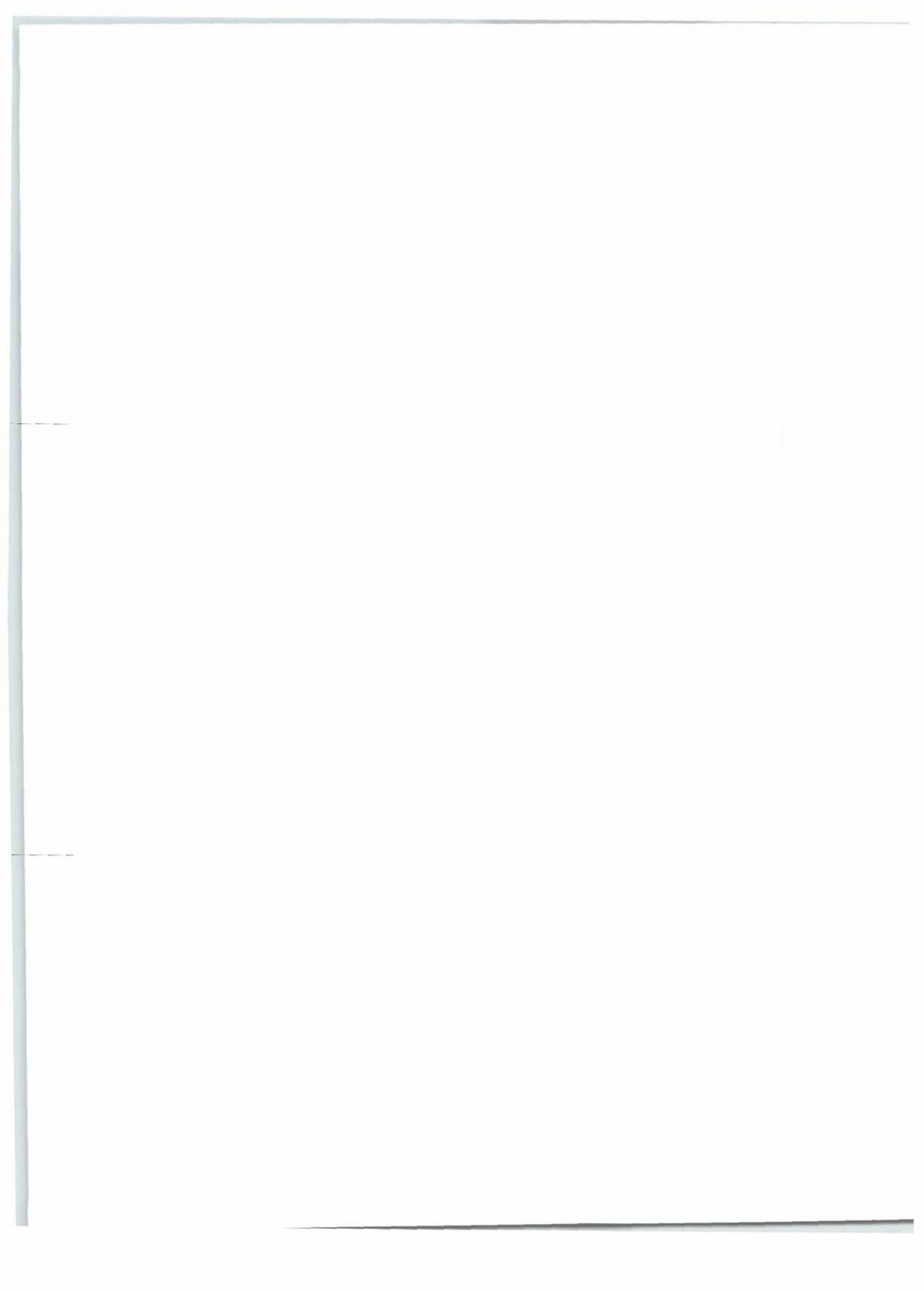
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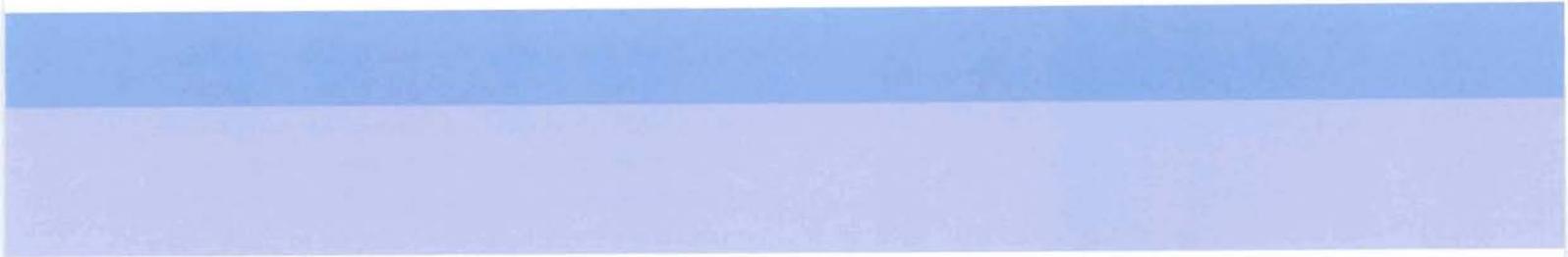




# Executive Summary







# Executive Summary

This Economic Report is the first by the World Bank on the economy of Himachal Pradesh (HP), and the first on a hill state in India. It comes in the context of a request by the Government of Himachal Pradesh (GoHP) to assess the state's progress and longer-term prospects. The study has been prepared as the initial step towards enhancing the Bank's understanding of the development priorities and key constraints for HP.

HP is a unique state in many respects—most importantly because of the enormous success it has achieved over the past three decades, despite severe structural disadvantages of relative remoteness, environmental fragility, and a difficult hill terrain, characteristic of Himalayan states in India. The study sets out to document, first, the remarkable success that the state has achieved in terms of sustained growth and human development, and the underlying reasons in terms of supportive policies and social cohesion. In this respect, HP makes an important contribution to lessons of success for the other nine Himalayan hill states in India. The second, and more extensive

part of the Report, is forward-looking. It describes how it might be possible to build on the past success that HP has achieved, and, at the same time, address some crucial economic and social transitions that will be essential for the state to firmly secure its future: (i) a sustained increase in income levels along with an enabling environment for the private sector; (ii) the creation of suitable jobs based on enhanced productivity and skills of its young labor force that can shift from public to private sector employment; and (iii) the utilization of natural resources like hydropower, forests, and water resources wisely and well. There is every reason to be confident that HP can meet these challenges. The state's past enviable track record is testimony to the ability of its people and leadership to forge a social consensus and compact necessary to achieve such goals.

The Report seeks to provide an analysis of HP's current economic situation, and to lay out a menu of reform options that can help build on HP's considerable strengths and opportunities, and address some of the main challenges ahead.



## Himachal Pradesh: A “Unique” State with a Successful Past but an Uncertain Future

HP has some specific characteristics that set it apart from other Indian states. It is a relatively small state, with a hilly terrain, a supply of perennial rivers, and significant forest cover. On the one hand, the salubrious climate, abundant water resources, and natural touristic ambience can contribute to the expansion of important sectors like horticulture, tourism, and hydropower. On the other hand, HP faces specific development challenges arising from its high elevation, topography, resource dependence, and ecological vulnerability—as well as from a changing and more competitive international environment. The Government of India (GoI) has given HP the status of a “special category” state in recognition of these unique constraints, under which the state is the recipient of special central grants and incentives that have been instrumental to its development.

The state has several significant achievements, in spite of its natural constraints. After two decades of slow growth since it was granted full statehood in 1971, HP has registered more rapid growth than the national average since the 1990s, and the economy has shown increasing signs of diversification. The state is ahead of Indian averages for most indicators of human development, and on track to meet a majority of its Millennium Development Goals. In fact, HP is performing better than several more developed states in the plains along several dimensions of social and economic progress.

Supportive government policies, a transparent and accessible administration, a peaceful political environment, and central support have contributed to the state’s development. In particular, from a focus on building transport and infrastructure facilities immediately after its formation in 1971, HP has gradually assigned priority to expenditures in the social sectors, which has considerably expanded the availability of basic

social infrastructure and amenities, and helped build an educated and healthy population. HP has achieved per capita social sector expenditure which is currently about double the all-States average in India. The initial infrastructure investments have also started yielding dividends in terms of higher growth. Underlying this remarkable achievement has been an implicit social compact and cohesion that has stood HP well in the past and will continue to do so in the future. In particular, the state has benefited from wise leadership throughout the past several decades, irrespective of political affiliations—and that, in turn, has been based on strong public support for policies that have encouraged social development, and delivery of public services. Central assistance has been important in the process, but primarily because the state has managed it well to further development.

However, the sustainability of HP’s success for the future will depend on addressing three major transitions that the state faces. To a great extent, the state may be reaching the limits of one of its traditional sources or engines of its growth and social development: one that is heavily dependent on public spending, financed by borrowing and central assistance. It is thus important for the state to look towards self sufficiency in meeting its challenges.

The first important transition is to shift the **growth strategy** in HP from one that is still far too heavily dependent on public expenditures and debt—to an increasing focus on the broad-based contribution from other sources of growth, with an enabling environment for the private sector. To an important extent, the state has already begun to move in this direction: the primary sector has seen signs of diversification to high value cultivation, while the secondary and tertiary sectors have seen impressive expansion in recent years. However, much more needs to be done, and a critical role will be played by growth in emerging sectors like tourism. At the same time, the very heavy burden of the state’s debt and current expenditures will necessitate a sustained turnaround in its fiscal position. As they exist,



any reduction of privileges as a “special category” state or other fiscal risks such as wage revision following the Sixth Pay Commission awards could hurt HP’s already precarious fiscal situation. The argument, therefore, is not for continued dependency, but for charting a course that will make the state more self sufficient. A fiscal turnaround will be crucial to create the necessary fiscal space for the state to invest in the basic development needs on a sustainable basis, and hence achieve its considerable untapped growth potential.

The second crucial transition is to create the **productive employment opportunities** for HP’s young and increasingly educated labor force, so that reliance on the public sector as an employer of last resort goes down. A better growth strategy and improvements in the investment climate will play a crucial role, as will efforts to strengthen the quality and skills base of the state’s labor force in order to ensure the outcome of good jobs that the state needs to sustain incomes. Achieving this while improving the quality of public administration is a central challenge. The immediate political economy pressures to add jobs in the public sector will remain acute. However, this will need very careful management as, in the end, providing more unproductive public sector jobs will be self-defeating. Failure to meet such pre-conditions risk two additional problems: (i) high unmet expectations of a young labor force that could add to the fiscal burden for the state which already functions as an employer of last resort; and (ii) inability to transform the gains in the quantity of education per head to an appreciable improvement in incomes that can come only from a significant upgradation in the supply of skills and education.

The third critical transition that HP will need to make is to better manage its **environment and natural resources**. This must take several key directions. The potential for hydropower development, which is being realized at an accelerating pace, has to be judiciously and prudently managed to support the desired fiscal outturns and to invest in the future of the state. At the same time, the downside effects of hydropower

development on the environment, especially reduced water for downstream uses, will require much improved attention to ensure that society as a whole benefits, and that development is sustainable. Furthermore, a broader environmentally sustainable strategy will be essential, for forestry development, community projects, urban management, and water supply. Failure to take action against environmental degradation in a society dependent on its natural resource base could ultimately threaten future growth prospects. It is critical to address these challenges before they start to impact on the state’s successful socio-economic performance.

Meeting these three transition challenges will not be easy. Difficult choices in public policies will be needed, that mark some break from HP’s past development strategies. The role of the state, in particular, must change increasingly from a direct provider of services and jobs to being an enabler of HP’s human and natural resource development potential, and one where the core functions will need to be strengthened and its key institutions revamped towards a modern developmental state. If these three transitions are achieved successfully, HP could become the first hill state in India that is able to achieve sustainable and accelerated growth with broadly-based social development.

The Approach Paper to HP’s Eleventh Five Year Plan (2007–12) seeks to move the state in the direction of fiscal self sufficiency and towards the ends of broader social and economic development. The articulated development priorities for the state are faster and sustainable growth, and inclusive development. HP’s development priorities are a function of its unique socio-economic characteristics. Unlike the states in the plains, GoHP recognizes that growth opportunities lie in some specific sub-sectors in which the state has natural advantages. Even though human development indicators are among the best in the country, the state seeks to further improve living standards, especially for disadvantaged sections and in remote areas where there are issues of access to public services.



## Key Development Challenges and Policy Options

### Transforming Growth by Creating the Fiscal Space to Finance the State's Development Vision

The major constraint faced by the state in realizing its development vision is insufficient fiscal resources to finance its priorities. Improved expenditure composition and revenue efficiency will be the basis for the creation of fiscal space. Some recent positive developments—in terms of increased non tax revenue from the sale of royalty power and the state's 25 percent equity in the Nathpa Jhakri Hydropower project in 2004–05, higher tax revenue from the introduction of the Value Added Tax (VAT) since 2005–06, expanded central grants under the Twelfth Finance Commission (TFC) award in 2005–06, and compression of expenditure—have brought fiscal deficits down from over 12 percent in 2002–03 to about 4 percent in 2005–06. These efforts provide the springboard for deepening the fiscal turnaround.

First, **own tax revenue** needs to be enhanced by measures like: (i) improvement of *administrative efficiency* of the system by modernizing tax administration and plugging weaknesses in implementation in areas such as VAT or stamp duty; (ii) *simplification and rationalization* of rates comparable to other states (e.g., excise taxes, motor vehicles tax, registration duty, electricity duty); and (iii) introduction of *new and innovative taxes* like the “green tax” or the Professions tax.

At the same time, **non tax revenue** needs to be expanded, with a major source identified as the state's *natural hydropower potential*. It is estimated that revenues from the sale of royalty power and/or a share of the power generated proportional to equity invested by GoHP in hydro projects with other partners (e.g., GoI in the case of Satluj Jal Vidyut Nigam) could be above 2 percent of GSDP by 2012–13. These revenues

would be more than 37 percent of HP's current level of revenue receipts and more than double the current level of own non-tax revenues. However, efforts should not be confined to the hydropower resources alone. Comparisons show potential for raising royalty from *user charges*, in particular. This requires a depoliticized institutional mechanism that can periodically decide on appropriate user charges.

**Expenditure** compression efforts should be married with efforts to improve its composition—so as to contain *salaries and pensions* in particular, and gradually phase out *non-merit subsidies*, while expenditure is reallocated towards *non-wage O&M* and *capital expenditure* in critical sectors, on the basis of fully budgeted maintenance plans for fixed assets. A formal process to critically review and rationalize ongoing programmes that institutionalizes zero based reviews—possibly by establishing some form of an *Expenditure Review Committee*—would be a useful supplement to the existing **annual** budget process, and will also help ensure efficiency of ongoing initiatives.

In addition, the state needs to better manage **debt and contingent liabilities**. HP is a debt-stressed state, with an unsustainably high debt stock of about 74 percent of Gross State Domestic Product and moving towards sustainability could help contain interest payments. Approximately 45 percent of the state's high cost debt stock comes up for repayment over the next five years, presenting a good opportunity to the state to restructure high cost debt. Fiscal risks from the operations of poorly performing state owned enterprises and boards must be minimized by implementing a reform strategy for these entities already outlined by GoHP in 2000. Moreover, an institutional mechanism to evaluate contingent risks and eliminate off-budget borrowings must be developed. The risk weighted guarantee exposure can be limited by suitably amending the ceiling under the HP Fiscal Responsibility and Budget Management Act.

The state has produced **Medium Term Fiscal Projections** (MTFP) that were tabled along with



the Budget for 2006–07, but these are based on very optimistic assumptions. The state needs to refine the MTFP by strengthening policy links and demonstrating prioritization through reallocation of expenditure, for instance to capital outlay and non-wage Operations and Maintenance (O&M), besides being consistent with TFC recommendations.

## Changing the Role of the State to Encourage Productive Employment and Suitable Jobs

Even though HP has grown marginally faster than the rest of the country since the 1990s, this performance follows two decades of slower growth—and the state needs to consolidate and sustain this performance if it is to move towards self sufficiency. HP has been unable to tap the full growth potential in sectors like tourism and horticulture, in which it has significant natural advantages. While manufacturing has grown in recent years, this is largely on account of special tax incentives that have attracted investments in the border districts near Punjab and Haryana. These investments may dry up once the sops are phased out in 2010, unless steps are taken to improve the business environment.

Low productivity of employment and a mismatch between skills and opportunities is a related concern for policy-makers. Despite signs of diversification, 70 percent of the population still depends on the agriculture and allied sectors—which provides just 22 percent of Gross State Domestic Product (GSDP). Though manufacturing employment has been generated in the industrial belts as a result of the state's industrialization strategy and central tax sops, there is evidence of a mismatch between skills required by upcoming industries and the education provided in the state. Consequently the public sector still remains the preferred source of organized sector employment, contributing to fiscal pressures.

In order to address these challenges, GoHP needs to adopt a two-fold strategy.

- ***Improving the General Business Environment for Private Sector Participation.*** Private industry representatives cite skills of available workers and poor infrastructural facilities as key factors affecting the investment climate. At the same time, unemployment rates among the educated graduates and post-graduates are rising. Accordingly, GoHP needs to focus on assessing and projecting the skill needs of the secondary and tertiary sectors; better matching the provision of technical and vocational training opportunities to market opportunities; and on improving the general quality of education with a view to increasing employability. Simultaneously, the state should step up efforts to alleviate infrastructural constraints, especially in rural areas and around the upcoming industrial agglomerations. Improved connectivity could help attract the private sector to remote districts. Since most secondary and tertiary sector industries tend to come up in an urban environment, promoting the development of urban infrastructure can also help to improve the business climate.
- ***Encouraging the “Right” Sectors.*** The state's natural situation makes it an unlikely candidate for a strategy based on heavy industries or traditional agriculture. Growth and employment potential in high value-added sectors like tourism and horticulture should be exploited—not only by encouraging private investment, but also by directly addressing specific constraints to the productive expansion of these sectors. For example, efforts to improve air connectivity, and revamping the marketing and branding strategy to project HP as an attractive destination for health or eco-tourism would be particularly important for the tourism sector which has so far failed to attract high-end customers. Activation of the recently established Tourism Development Board would help promote inter-departmental coordination. In order to promote sustainable growth in agriculture, it is important to focus on the: (i) expansion and intensification of irrigation, with particular attention to rationalizing user charges which cover only about 2.5 percent of O&M costs, and



moving toward farmer management of schemes; (ii) rationalization of the subsidy regime, which is inconsistent in its focus on organic farming on one hand and chemical inputs on the other; (iii) modernization of research and extension services; (iv) acceleration of the process of diversification into high value crops; and (v) promotion of better marketing, with involvement of private parties.

## Strengthening the Institutional Environment for Inclusive Growth

While HP has recorded impressive achievements in human development based on objective indicators, there are avenues to improve governance and public administration. In fact, user satisfaction surveys show that there is room for better public service delivery as well. Appropriate measures as outlined below would also help contain the fiscal pressures, and improve public administration and transparency.

- In order to enhance **administrative efficiency**, the state could: (i) reduce *staffing ratios*, which are among the highest in the country at about 4.5 civil servants per 100 population, and resulting fiscal pressures—based on a departmental review of positions, units, and human resource needs; (ii) *rationalize government* by clustering related departments, instead of ad hoc clustering of portfolios across various levels of government, and by improving the speed and transparency of file movement; and (iii) improve the *tenure and stability* of civil servants to promote effective implementation of programmes by enforcing the average tenure of a minimum of three years, consistent with HP's transfer policy, while discouraging politicization of transfers and recruitment.
- Although corruption appears to be low in the state as per the Transparency International indicators which identify HP as the second least corrupt state in India, **transparency and accountability** can be improved by: (i) aggressively implementing

the relatively less-used central *Right to Information (RTI) Act*; (ii) strengthening the powers and capacity of the *Lok Ayukta*; and (iii) reverse signs of weakening *police capacity*—as reflected in declining overall conviction rates in recent years—to enable the Department to provide effective law and order services. *E-governance* can be a useful tool for simplifying transactions and making it easier for the population to access government services, and the sector should be strengthened by focusing on a few flagship projects of the 40-odd e-governance projects at present, along with business process reengineering where appropriate.

- There are some issues around **skills and quality** of local providers—especially in health, where specialists are in short supply in remote areas, and in education, where teacher absenteeism and lack of appropriate teacher training impact on service delivery. In order to improve delivery mechanisms, the state needs to: (i) promote *decentralization*, which could strengthen Panchayati Raj Institutions' control over local level providers; and (ii) provide in-service and pre-service *training* to providers to equip them to deliver quality services.

## Improving Human Development and Social Protection Strategies

Poverty rates are low at under 10 percent, and social development indicators are good in general—in many cases, better than in richer states. However, the state faces the challenge of promoting inclusive development for disadvantaged groups and remote areas. In addition, there are some “second generation” problems in view of economic development and diversification—which include issues around quality and private participation, for example. These go beyond basic “first generation” issues of access to services that affect other less-developed states.

- Social **infrastructure facilities**—including Primary Health Centers in some areas, school buildings and toilet facilities—need to be



developed, and the state could experiment with pilot initiatives like mobile units or telemedicine to reduce fiscal costs of provision of static units.

- **Public private partnerships**—such as encouragement to private universities and medical facilities—could be an important avenue to strengthen delivery mechanisms. These could reduce fiscal pressures, as well as improve service quality.
- The **social protection system** faces the challenges of: (i) improving *existing safety nets* through better administration and record keeping, stronger involvement of PRIs, and periodic impact evaluations going beyond concurrent ex-post evaluations undertaken at present; (ii) developing a *social care strategy* for the state's future needs, in partnership with private partners and civil society, and (iii) expanding *social security* to the unorganized sector, which is particularly underserved in terms of health and crop insurance.

## Improving Institutions to Manage Environmental Assets

HP's rich and varied natural heritage provide both opportunities and risks to its development strategy. Natural resources are a critical, if underutilized, engine for accelerating growth and poverty reduction. At the same time, resource dependence renders the economy highly vulnerable to the consequences of environmental degradation.

The current approach to environmental management is fragmented and it is treated as a “clearance” requirement to be obtained from, for example, the Forest Department or the State Pollution Control Board. Problems tend to be addressed retrospectively only when they become highly visible. Current development patterns raise concerns about the efficiency, competitiveness, and sustainability of resource use—especially given the fragility of the states resources. Prudent economic management calls for environmental issues to be fully integrated into economic policy and mainstreamed in

various sectoral activities—especially in sectors like tourism, manufacturing, hydropower, industry, and forestry, where activities can have significant impacts on the eco-system.

- The **institutional approach** to environment management should be improved, particularly by: (i) promoting *inter-departmental coordination* to ensure convergence of environmental objectives and minimize intersectoral conflicts; (ii) strengthening the *Environment Department*, which is currently at a very nascent stage with insufficient capacity and powers, in order to capitalize on the state's comparative advantages and use environmental resources as growth drivers; (iii) improving the *information database*, at least in key sectors which have wide environmental consequences; and (iv) preparing an *Environment Policy* supporting development goals, and providing a holistic view of the growth-generating potential of natural resources, as well as the limits and carrying capacity of key resources.
- However, beyond organizational structures, there is a greater need for more innovative reforms in **environment management**. For example, an *area based environment management approach*, provides one way of clustering the pollution footprint of industries, and could be a valuable tool for a fragile hill economy like HP. Expanding *public participation*—for example, by encouraging community involvement in the context of specific development projects, and building the capacity of government agencies for more effective public consultation—is another avenue that GoHP must explore, since public participation in environmental decision making is typically low in the state. Environment management is particularly important in the context of development of *hydropower resources*.

## Tapping Hydropower Resources Efficiently and Sustainably

Hydropower has huge untapped potential on account of the state's supply of five perennial rivers. Judicious



exploitation of the unrealized potential of over 12,000 MW in an environmentally sustainable manner assumes particular significance, not just as a source of “green energy” than can help alleviate the power shortage in the Northern Grid, but also as a critical source of non-tax revenue as described earlier. Revenues from the sale of free power available to the state from ongoing and new hydropower projects alone could reach Rs. 9–11 billion by 2012–13.

Given that a number of new hydro projects involving various public and private players are expected to come up, it is important to proceed expeditiously with reforms in this sector, since lack of clarity can be detrimental to the investment climate. Key actions that require attention include: (i) setting up institutional mechanisms for sustainable hydropower development—including integrated planning based on river basins as against the current piece-meal approach of development of individual projects, and mechanisms to monitor and implement environment management activities related to hydropower development to ensure that these activities are completed before projects are commissioned; (ii) carrying out a strategy study on the model HP should follow in building up new hydropower projects as well as for trading power, and on managing the revenues flowing from the hydropower development to ensure maximum benefit to the state and for those affected by development; and (iii) implementation of the Electricity Act of 2003, including appropriate institutional restructuring of the HP State Electricity Board (HPSEB), separation of the trading function from the transmission function, and facilitation of open access.

## A Possible Reform Agenda

Policy suggestions can only be a first step—it is critical to implement the policies that can help the state realize its development goals. GoHP needs to craft an overarching programme for the state to guide reform, identifying the policies that it would like to

implement. This agenda should be communicated across government and stakeholders in order to build support for its implementation.

It is particularly important to pay close attention to the sequencing and prioritization of reforms, and to move more rapidly on policies where there is likely to be quicker and visible returns. Accordingly, the Report suggests a menu of reforms that GoHP could consider over the next few months, based on GoHP’s own vision, and under consideration by the government. It is proposed that GoHP and the Bank use this for further discussions.

Given the complexity of the task, a flexible approach to prioritization and sequencing is suggested—by which GoHP identifies those reforms which are the most pressing, implementable, and likely to yield significant returns, in order to develop a cohesive programme that is reflective of and consistent with the state’s vision. As a first step, this assessment suggests that GoHP address the fiscal constraints on a priority basis—backed by governance reform measures to curb the salary bill. At the same time, it would be important for GoHP to take steps towards making the transition from a state-led to a private sector oriented economy, and it is important to signal clear intent in this area. In order to address employment issues, GoHP should begin the process of assessing and projecting skills and education requirements. The state should take steps to promote sectors with untapped potential—and could consider measures for hydropower and tourism development as priorities. Simultaneously, measures to conserve and protect the environmental heritage—both in the context of hydropower development, and in terms beginning the process of developing an Environment Policy—should also receive priority attention.

It is also important to keep in mind that deeper institutional reforms identified in this Report will need more time and careful preparation, and can form the basis for more intensive dialogue. In fact, even the near



term reforms proposed by the Report are initial steps that build towards reforms to be implemented over the medium term. Hence, these should not be considered “one-off” measures—but as part of a longer term reform vision.

It is to be noted that, subsequent to the preparation of the Economic Report, several reform measures and commendable new initiatives have been proposed in selected priority areas. These reform measures, as well as some data updates, are discussed in Annex 1.

## A Menu of Near Term Reform Options

### Sustaining Growth through Fiscal Recovery

- The state must refine its **medium term fiscal projections**, incorporating a clear policy basis demonstrating expenditure reallocation to capital outlay and non-wage O&M in critical areas, to reflect stronger reform outcomes consistent with TFC recommendations. These could incorporate analyses of different scenarios and downside stress tests.
- In order to enhance **own-tax revenues**, the state could: (i) switch from a specific to an ad valorem *excise* duty structure, as in Maharashtra; (ii) simplify the *license fee* structure for alcohol vending; (iii) initiate a comprehensive review of the revenue implication of the current *motor vehicle tax* regime; (iv) re-introduce the *Professions Tax*; (v) begin evaluation of *VAT implementation* with a view towards improving the administration; and (vi) initiate an *analysis of stamp duty* evasion and their revenue impact to prepare for more fundamental reform.
- In order to enhance **non-tax revenues** from user charges, GoHP could establish a Public Tariff Commission for various services like transport, education, health, water, and irrigation in order to depoliticize the determination of user charges.
- In order to curb and improve the composition of **expenditure**, the state could: (i) implement an effective *wage and hiring* policy consistent with fiscal sustainability; (ii) complete *pension projections* for government and public sector agencies, and begin **annual budgeting on an actuarial basis**; (iii) reduce *power subsidies*, and delink it from the power tariff; (iv) introduce a *contributory pension scheme* at par with government employees for new employees, with pensionable pay, in Public Sector Boards, Corporations, Universities, and Local Bodies; (v) appoint a *Committee* to examine containment of expenditure under subsidies and a gradual phase out of non-merit subsidies; (vi) initiate the process of identifying schemes that have lost relevance, and restructuring and rationalizing them by constituting an *Expenditure Review Committee* to critique ongoing programmes; (vii) and *reallocate* expenditure towards non wage O&M expenditure in critical sectors, and capital outlay.
- In the area of management of **debt and contingent liabilities**, GoHP could: (i) merge *off-budget borrowings* with budgeted borrowings, and eliminate future off-budget borrowings; (ii) risk weight *guarantees* and begin reporting them; (iii) revise the *target for risk-weighted guarantees* under the FRBM after eliminating off-budget borrowings; (iv) establish a set of *formal rules* to govern eligibility of Public Sector Enterprises (PSEs), cooperatives, and statutory boards for government guarantees, taking into account financial statements, record of profitability, performance on past guarantees, priorities of government, etc.; and (v) make progress towards the implementation of the reform strategy for *state-owned PSEs* outlined by the government in its order dated October 20, 2000, including initiation of the preparation of a turnaround plan for the HP Road Transport Corporation.
- In order to **modernize tax administration**, the state should initiate steps towards: (i) creating the necessary *organizational basis* for separating and strengthening the key tax administration functions; (ii) introducing *multiyear strategic planning processes* underlying annual business plans; (iii) improving the *accountability mechanism* to move from collection-based accountability to wider reforms; (iv) strengthening the *human resources* in the Excise and Taxation Department; and (v) making the Excise and Taxation Department the basis for a *unified tax collection system*.
- In the area of public **financial management and procurement**, GoHP could: (i) *modernize the Himachal Pradesh Financial Rules, 1971*, which need to be updated and simplified; (ii) replace the existing Procedure & Rules for the



### A Menu of Near Term Reform Options (Contd...)

Purchase of Stores with a *public procurement* law that can apply to all procurement undertaken using public funds (goods, works and services), and which can be piloted in 2–3 departments and PSEs to ascertain the benefits; and (iii) roll out *treasury computerization* to cover the entire state.

- In order to strengthen the **budget formulation process**, a fiscal strategy paper could be presented to the Cabinet preceding the budget preparation process, communicating departmental expenditure ceilings and fiscal projections as part of the budget call circular.

#### Improving the Investment Climate for the State for Private Sector Development

It is particularly important to undertake a study to identify the extent of **skills gaps and mismatches**, including a skills-mapping exercise, to identify particular sectors which would emerge in the near future, so that skill requirements could be projected.

- In the **roads** sector, GoHP is undertaking an assessment of the costs and benefits of the gang labor system, and recommendations from this should be finalized for implementation.

#### Tapping the Growth Potential in the “Right” Sectors

- In order to promote sustainable development in **agriculture**, GoHP could: (i) review and rationalize *the subsidy regime*, especially in view of inconsistency between encouragement to organic farming and subsidies to the consumption of chemical fertilizers and pesticides; (ii) prepare a *strategy* with an implementation time table and progress indicators, aimed at increasing currently low user charges to reach full cost recovery within a designated time period, and an action plan for devolving suitable irrigation schemes to beneficiary farmers.
- The state should activate and empower the **Tourism** Development Board that has been recently established under the chairmanship of the Chief Minister as a forum for better inter-sectoral coordination and strategic approach for tourism development in the state.

#### Improving the Institutional Environment for Inclusive Growth

- In order to tackle the problem of **overstaffing and high wage bill**, GoHP could: (i) enforce a *strict ban on recruitment*, especially for non-regular employees as well as Class IV employees in the regular civil service, and work-charged and part-time workers in overstuffed departments, and curb regularization; (ii) *identify redundant posts* by conducting functional reviews in major departments, assessing whether current staffing patterns exceed established norms, revise existing norms to take into account technological improvements, and identify posts that could be outsourced to the private sector; (iii) *establish an HP Pay Commission* to decouple salary structures from those in Punjab, that would, over time, chart an independent course for determining the state’s salary structure in view of political sensitivities; and (iv) implement a *Voluntary Retirement Scheme* (VRS) for government employees who wish to leave government service and compulsory retirement provisions in the All-India Service Rules to remove inefficient staff from service.
- In order to promote **transparency and accountability**, (i) the suo-motu provisions of the RTI should be aggressively implemented, especially through posting of suo-motu information on the web, and providing departmental websites to those still lacking the same; (ii) the *Lok Ayukta* should be strengthened by amending the Lok Ayukta Act to allow for *suo-motu* powers to take action in cases without a formal complaint, by providing qualified legal and other staff to assist him, and by widening the definition of corruption to include grievances arising out of maladministration; and (iii) the recent weakening of *police capacity*, as demonstrated in declining conviction rates, should be reversed by implementing the recent Supreme Court directive to create a State Security Commission to insulate the force from political pressures, and enforce a minimum tenure of three years for the Director General of Police and senior officers.
- For **administrative rationalization**, GoHP could: (i) review current *functional clustering* of administrative responsibilities, with a view to clustering like Departments; and (ii) strictly enforce the minimum *three-year tenures* as per HP’s transfer policy, by establishing statutory committees to authorize transfers and postings for senior



## A Menu of Near Term Reform Options (Contd...)

officers, and creating a stability index to ensure that the average tenure of the IAS cadre as a whole does not fall below three years.

- In e-governance, **priorities** for the IT Department—from among the 40-odd projects underway—should be clarified, and implementation should be sequenced based on departmental capacity and need.

### Strengthening **Human Development and Social Protection** Strategies

- In **education**, it is important to implement measures under consideration to *partner with the private sector* in the provision of technical and higher education—like using private parties to provide technical and vocational education using the state's existing educational infrastructure.
- In **health**, a study proposed by GoHP on assessing the efficacy of *mobile vs. static units* could contribute towards addressing the problem of health service delivery in remote areas.
- In **social protection**, the state could: (i) carry out a *rapid review* of administration and record-keeping in key social protection programmes, in order to develop options for improved performance; and (ii) initiate a third party *impact evaluation* of social pensions—the single largest intervention for the poor in the state.

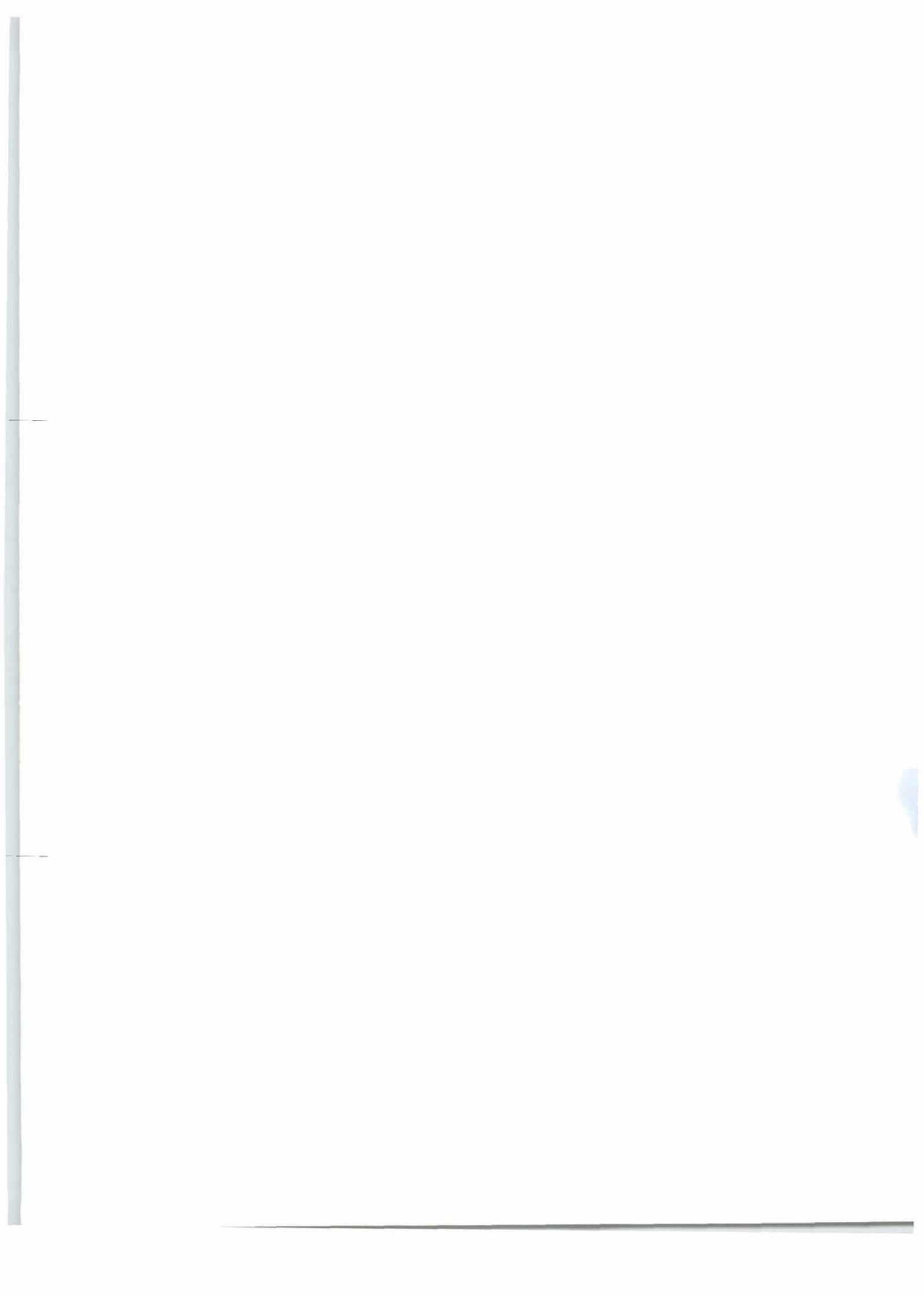
### Promoting Environmental Sustainability

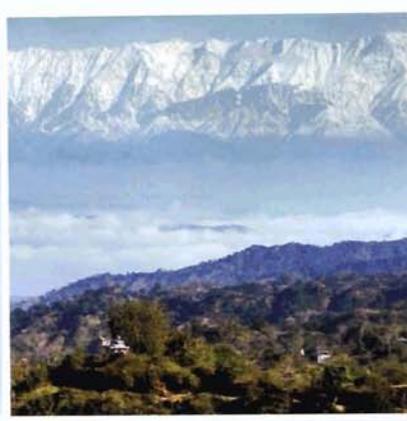
- GoHP could **strengthen the Environment Department** and develop capabilities which would help to systematically assess how the state can maximize its natural advantage, and to ensure application of environment norms across sectors.
- GoHP could initiate an **institutional and “gap” analysis of the environment sector** that could feed into the subsequent preparation of an Environment Policy. This would include: (i) assessment of environmental pressures in various areas in the state; (ii) identification of regulatory, institutional, and policy gaps leading to these pressures; (iii) assessment of workload and implementation capacity for the Environment Department, Forest Department, and the State Pollution Control Board; (iv) strengthening of compliance and efficiency by assessing alternative ways of implementation of development projects; and (v) assessment of adequacy of the existing range of policy instruments and feasibility of using new ones that target the systemic and root causes of policy failure.

### Managing the Hydropower Potential Efficiently and Sustainably

- The state should set up an **institutional mechanism** (including its structure and functioning) to monitor and implement environment management activities (catchment area treatment plan, compensatory afforestation, conservation of wildlife, etc.) related to sustainable hydropower development in HP, in order to ensure that these activities are completed in a time bound manner before the projects are commissioned. Implementation of activities can be outsourced to either the developers themselves or private contractors, through discrete time bound contracts with periodical monitoring and evaluation of performance by the regulator and the developers.
- In order to optimize the returns from the hydropower resources with due regard to the risks involved, and better manage hydro revenues, a **strategy study** should be undertaken to: (i) assess the model that state should follow in building up new hydropower projects—through state/central/private/joint venture routes or a combination of these; and (ii) recommend best utilization of the hydropower revenues to ensure optimum benefit for the state and affected people.
- In order to encourage **integrated river basin planning**, the state could facilitate the proposed study on Satluj river basin with a view to developing a time-bound action plan based on recommendations emerging from the study.
- It is important to implement recommendations of the **Electricity Act 2003**, including facilitation of open access, separation of power trading function from the transmission function, and appropriate restructuring of HPSEB.



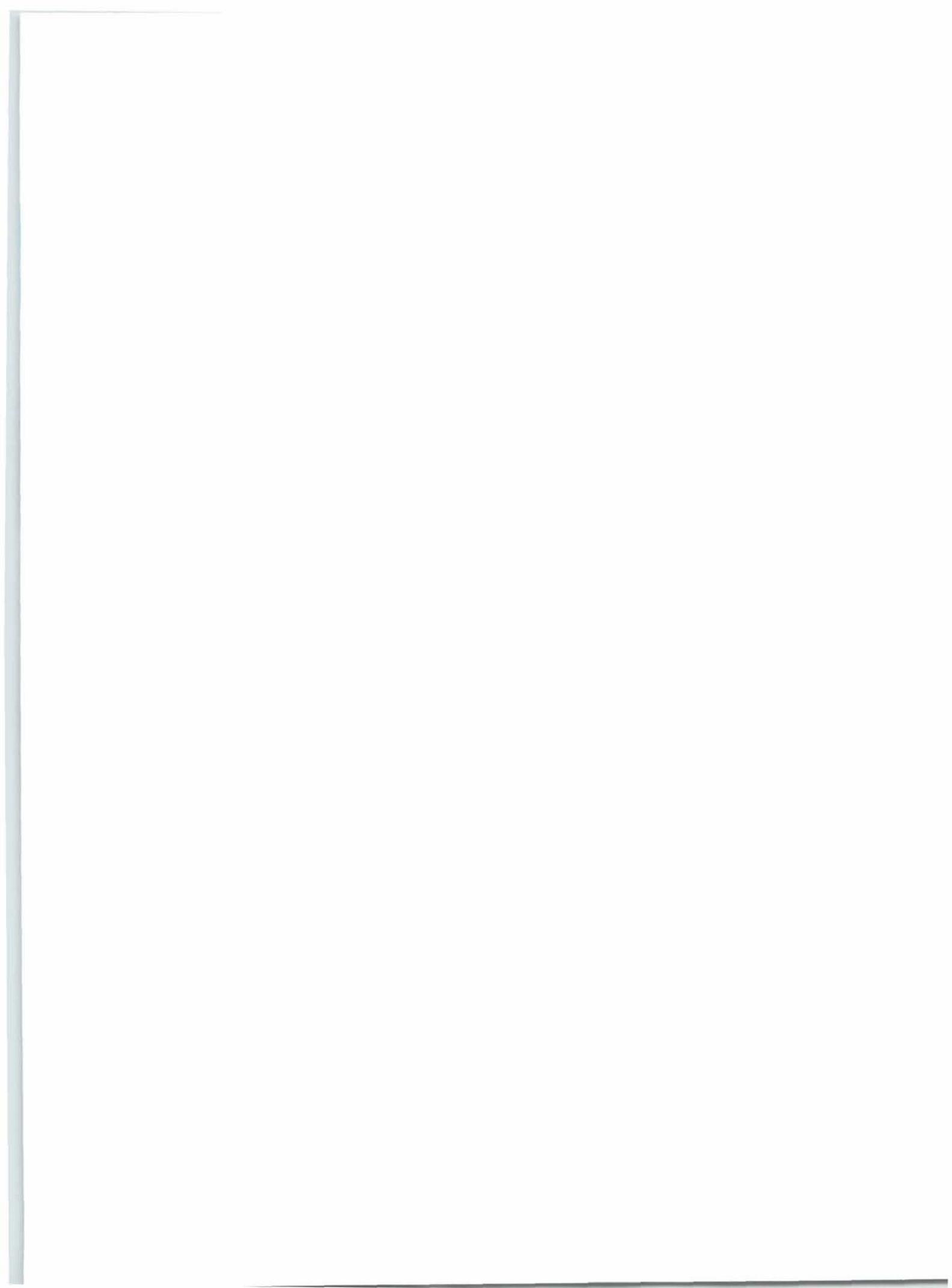




01

# Himachal Pradesh: A State with a Difference





# Himachal Pradesh: A State with a Difference

This Economic Report is aimed at enhancing the World Bank's understanding of the development priorities and key constraints for the hill state of Himachal Pradesh (HP), with a view to identifying strategic policy options for the Government of Himachal Pradesh (GoHP). This is also the Bank's first cross-sectoral assessment for any of India's "special category" states, as well as the first comprehensive study undertaken for any of the country's hill states.

The Report is based on the Bank's analysis of HP's considerable potential and opportunities, as well as the key challenges facing the state. It is primarily a forward-looking assessment of possible reform priorities and actions that the state can consider in the short-to-medium term to help realize its development vision. The assessment draws largely on existing data and information that was available till December, 2006, supplemented by discussions with officials of (GoHP), and members of academia, civil society, and industry groups.<sup>1</sup>

The Report is structured as follows. Chapter 1 presents a brief review of the state's recent performance, and overall development vision in terms of sustainable growth and inclusive development. Chapter 2 examines the challenges and options in sustaining and assisting the state's fiscal recovery, in order to create fiscal space to help realize the state's development vision. Chapter 3 analyzes some of the key constraints to private sector participation, which leaves HP dependent on the public sector. Chapter 4 looks at ways in which HP can exploit untapped potential in sectors like hydropower, horticulture, and tourism, where it has natural advantages. Chapter 5 analyzes the key issues facing HP in terms of governance and public administration, and recommends measures to improve the institutional environment. Chapter 6 looks at outstanding issues in the human development and social protection sectors, where the state boasts of particularly impressive achievements. Chapter 7 highlights the importance of conserving the environmental heritage, given that the

<sup>1</sup> Annex 1 provides an update of policy options proposed by GoHP following preparation of this Report.



**Table 1.1: Local Context, Key Indicators, and Location of HP**

Number of Administrative Districts	12	
Next State Assembly Elections Due	2008	
Population (Million, 2005–06)	6.6	
Percentage Rural Population	90.2	
Percentage Scheduled Castes and Tribes	28.7	
Adult Sex Ratio	968	
Area (1000 sq. km.)	55.7	
Nominal GSDP (Rs. Billions, 2005–06)	223.8	
Nominal GSDP Per Capita (Rs., 2005–06)	33,825	
Ruling Party	Congress	
State Capital	Shimla	

state's future potential lies in mainly its natural resources. Chapter 8 lays out a menu of near term reform options that can help build on HP's strengths, and address some of the constraints.

## A. State Background and Recent Performance

### A "Unique" State in the Indian Context

HP has some specific distinctive characteristics that set it apart from other Indian states. First, it is a relatively **young state** in the Indian union. It has existed since 1948 as a Chief Commissioner's Province comprising of 30 princely states, and a state area reorganization transferred parts of Punjab to HP in 1966. The state, which currently comprises of 12 districts, was granted full statehood in 1971. Second, HP is a **small state** both in terms of area and population. It has a population of about 6.6 million which is well under one percent of the Indian total, of which above 90 percent still reside in rural areas. The state accounts for only about 1.6 percent of the national geographical area. Third, it

is **geographically different** from most Indian states located in the plains. HP is largely mountainous, except for a few pockets bordering Punjab and Haryana—with altitudes spanning from 400 meters to almost 7000 meters above sea level.<sup>2</sup> Of the aggregate geographical area, almost two-thirds are officially classified as forests—though actual forest cover is lower. The hilly terrain and forest cover contribute to low availability of land for agriculture, and net sown area is only about 15 percent of the total. The population density in the state—at around 110 per sq. km.—is significantly lower than the national figure of 320 per sq. km., largely due to relatively low and scattered population in the hill and forest areas.

HP's unique characteristics present several important development opportunities which the state can exploit. It is rich in natural resources with abundant water supplies, minerals, forests, biodiversity, and fertile soils. The rich and varied forests are a crucial livelihood resource that protect the soil and provide fuel, fodder, and a wide variety of non-timber forest products. Forests are also important for protecting the many rivers that flow beyond the state to serve the Indo-Gangetic plains. The Himalayan region is one of the

<sup>2</sup> Physiographically the state is divided into four regions: the Shivalik Hills have a relatively low average elevation of 1,000 meters and are characterized by a network of streams, the Lesser Himalayas rise to an average of 3,300 meters and support rich forests, much of the Greater Himalayas lie above the tree-line with elevations of 5,500, and the Trans-Himalayan zone is the geographic continuum of Tibet, marked by cold alpine deserts.



world's priority biodiversity areas, and HP is one of the few Indian states with virgin primary forests. The parts under rainforests and alpine forests are home to some endangered wildlife species. The state is rich in flora and fauna, with many glaciers, passes, meadows, and trekking routes. The salubrious climate, supply of perennial rivers, and natural touristic ambience can contribute to the expansion of important sectors like horticulture, tourism, and hydropower.

At the same time, these special characteristics also pose several constraints to development—on the basis of which HP has been conferred the status of a “special category” state by the Government of India (GoI).<sup>3</sup> HP confronts environmental problems that are common across the country—such as pollution, soil degradation, and declining forest quality—but with its high level of dependence on natural resources, it is especially vulnerable to the consequences of environmental decay. The ability to diversify the economy is limited by rugged topography and poor market access, which render large scale industrialization costlier and more difficult than elsewhere in India. The state's mountainous terrain and remoteness of much of the population increase the difficulties of infrastructure development, urbanization, traditional agriculture, and efficient public service delivery. In addition, pockets of poverty remain in remote areas, the small population implies a limited tax base, and inadequate infrastructure limits the opportunities for private sector development. GoI has given HP the status of a “special category” state in recognition of these specific constraints, under which the state is the recipient of special central grants and incentives that have been instrumental to its development.

On account of HP's uniqueness, the more developed states in the Indian plains can only provide limited guidance for HP's progress, and the state needs to chart its own course. HP faces specific development challenges

arising from its high elevation, topography, resource dependence, and ecological vulnerability—as well as from a changing and more competitive international environment. In order to unleash its full potential, there is a need for the state to play to its considerable strengths and capitalize upon its comparative advantages which lie in its abundant natural resources that have to be sustained.

## HP's Recent Past: A Socio-Economic Success Story

The state has several significant achievements, in spite of its natural constraints. Even though national norms are not the most accurate comparator on account of HP's uniqueness, it is interesting to note that it is ahead of Indian averages for most indicators of economic growth and human development.

### *Significant Economic Growth and Diversification*

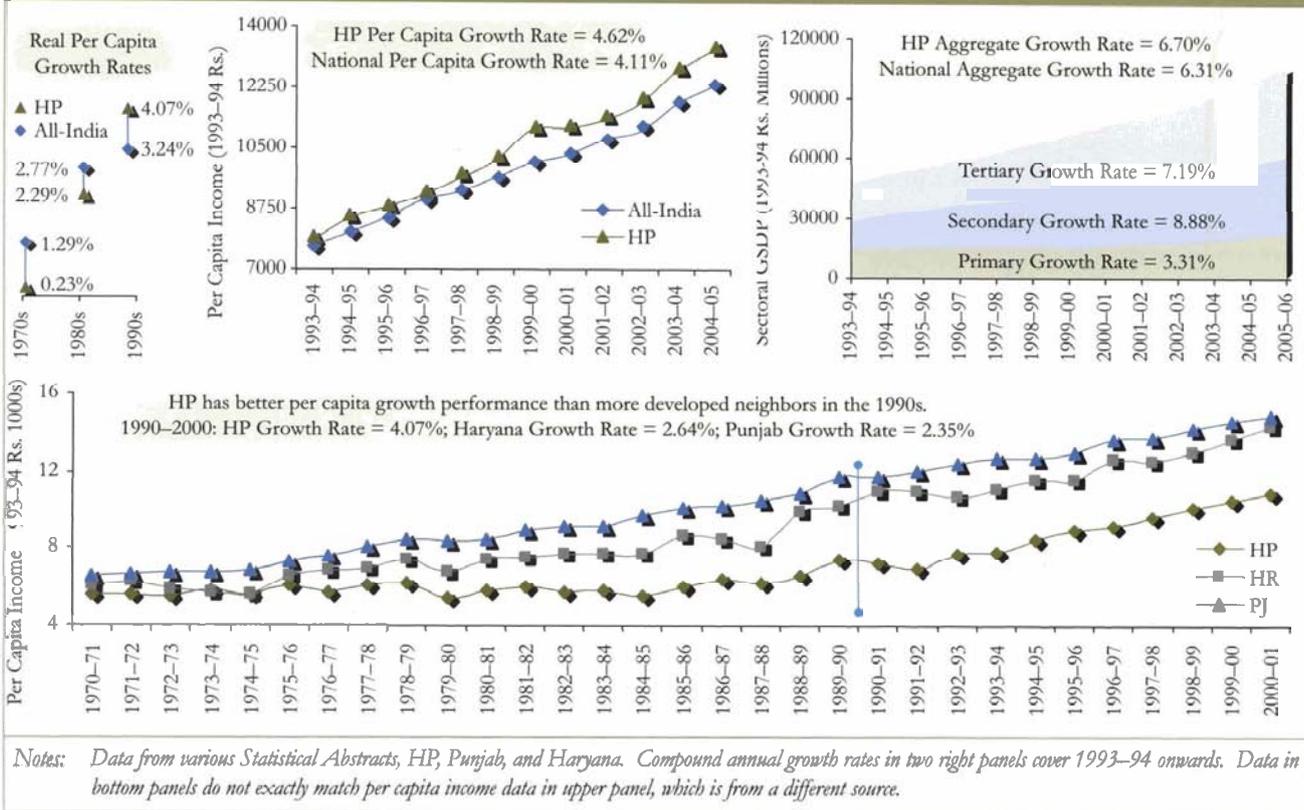
The state experienced slower growth than the rest of the country during the 1970s and 1980s (Figure 1.1). HP had a weak socio-economic base when it was formed, partly on account of prior neglect due to its geographical constraints. Though it began with higher per capita income and better social indicators compared to the rest of the country, it was seriously disadvantaged in terms of infrastructure, and depended heavily on the primary sector which contributed almost 60 percent of Gross State Domestic Product (GSDP) in 1971. HP had actually fallen marginally behind national average per capita incomes in the early 1990s—partly due to initial investments in basic physical and social infrastructure which did not show immediate results in terms of growth.

Over the last decade, however, HP has achieved higher levels and growth rates in income compared to the

<sup>3</sup>“Special category” states are those having characteristics like strategic border locations, hilly terrain, inadequate infrastructure, large tribal population, and limited resource bases compared to development needs. There are eleven “special category” states in India.



Figure 1.1: Recent Performance in Real Economic Growth and Diversification in HP



average Indian state, and the economy is showing increasing signs of diversification (Figure 1.1). In fact, HP has grown faster than states like Punjab, Haryana, Maharashtra, Tamil Nadu, and Andhra Pradesh during this period (Figure 1.1). The secondary and tertiary sectors have expanded more rapidly than the primary sector—helped by tax exemptions and special incentives since 2003 that have attracted investment in these sectors.<sup>4</sup> In contrast, the share of the primary sector has dwindled from 32.1 percent of GSDP in 1993–94 to 21.4 percent in 2005–06—comparable to the Indian average of about 19.6 percent (Figure 1.1).

### Positive Achievements in Human Development

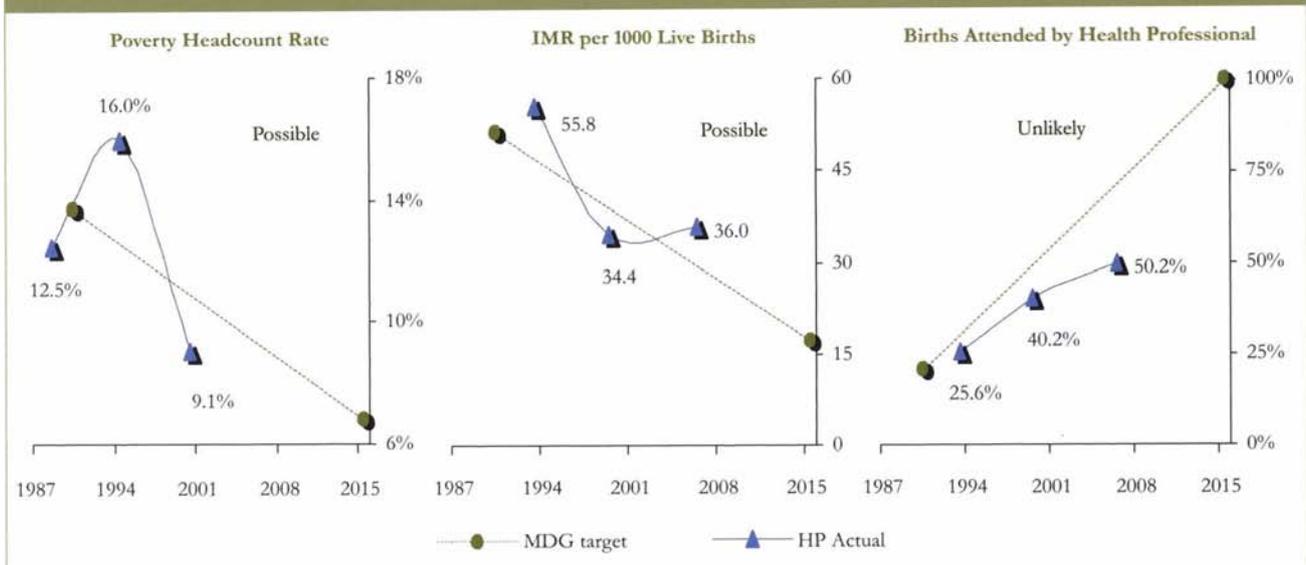
HP has human development and access indicators that are mostly better than the national averages on aggregate—and better than in richer states, despite the physical constraints.<sup>5</sup> In fact, if recent linear rates of change are maintained, the state is on track to attain—or has already attained—several important Millennium Development Goals (MDG) (Figure 1.2 and Table 1.2). However, concentrated efforts are needed to provide access to reproductive health services for all by 2015—where the MDG target may not be met on current trend.

<sup>4</sup> Historically, the boost to industrial development came in the early 1980s when a host of incentives were announced by the centre and state. The recent major incentives to industries in HP come in the form of GoI's Special Incentive Package of 2003 and GoHP's New Industrial Policy of 2004 which provide, among other things, a five-year tax holiday and ten-year excise relief to existing and new industries (revised to expire in 2010), and capital investment subsidies to new industries in notified locations and to old units in case of substantial expansion. These have elicited an increase in proposed investments. See Box 3.1 for details.

<sup>5</sup> See Annex 2 for an overview of key social indicators.



Figure 1.2: Will HP Attain Selected Millennium Development Goals?



Notes: Data from National Sample Survey and National Family Health Survey, various rounds. MDG target path derived from MDG statement, extrapolated from value of indicator in 1990. Linear projections to 2015 from actual data points are compared with targets.

Table 1.2: Summary of Key Millennium Development Goals for HP

MDG Statement	HP's Recent Performance	Likelihood of Attaining MDG
Halve, between 1990 and 2015, the proportion of the poor.	Poverty has declined from 12.5% in 1987–88 to 9.1% in 1999–00.	Possible.
Achieve universal primary education by 2015.	Enrollment for 6–10 year-olds has risen from 93% to 97% between 1993–94 and 1999–00, and for 11–14 year-olds from 88% to 94%.	Possible.
Eliminate gender gaps in education by 2005.	<ul style="list-style-type: none"> <li>For 6–10 year-olds, female and male enrollment rates were 97% in 1999–00.</li> <li>For 11–14 year-olds, female to male enrollment ratio has gone up from .902 in 1993–94 to .938 in 1999–00.</li> </ul>	<ul style="list-style-type: none"> <li>Already achieved.</li> <li>Possible by 2008.</li> </ul>
Reduce infant and child mortality rates by two-thirds between 1990 and 2015.	CMR has fallen from 69.1 per 1,000 in 1992–93 to 42.4 per 1,000 in 1998–99. IMR has fallen from 55.8 per 1,000 in 1992–93 to 36 per 1,000 in 2005–06	Possible.
Access to reproductive health services for all by 2015.	Births attended by a health professional have gone up from 25.6% in 1992–93 to 50.2% in 2005–06.	Unlikely. Projected to be just under 75% in 2015.
Reduce by half the proportion of people without safe drinking water between 1990 and 2015.	Population without access to safe water has fallen from 42.4% in 1992–93 to 22.6% in 1998–99.	Already achieved.

Note: Likelihood of attaining MDGs based on linear projections from available time series data (National Sample Survey and National Family Health Survey), recent available years. Poverty numbers from Deaton and Dreze (2002).



### Impressive Expansion of Physical and Social Infrastructure

The state has already achieved impressive expansion in infrastructural facilities such as electrification, banking, post office facilities, and teledensity.<sup>6</sup> All of HP's villages are electrified. Power generation in the state has been growing at 6–7 percent annually in the 2000s, and per capita consumption of electricity in the state is 831 kWh per annum, as against the national average of 613 kWh and an average of 565 kWh for the Northern region. Compared to a national average of 8.6 telephones per 100 population, the figure for HP was 12.5 in 2004—second only to Kerala. While there are only 0.70 primary and 0.25 secondary schools per 1000 population in India on average, corresponding figures for HP are 1.81 and 0.34—implying wider coverage of educational institutions. Likewise, in health, while a single Sub Center and Primary Health Center (PHC) caters to 5085 and 31954 people in India on average, figures for HP are much lower at 2651 and 12488 people respectively. These developments are particularly commendable given the natural constraints that the state faces in terms of terrain and remoteness.

### Major Factors Contributing to Recent Achievements

A shift in the state's focus from infrastructure to social investments has contributed to the state's impressive achievements. The state originally started with a very weak infrastructure base. For example, after India's independence in 1947, HP had the lowest road length per population in the country, and per capita electricity was less than 1 kWh compared to 17.8 kWh nationally. Initially, the government gave priority to infrastructure development, which required heavy investments in certain fields without immediate results—

and which resulted in low growth rates during the initial years of statehood (Figure 1.1). From an initial focus on building transport and infrastructure facilities, HP has gradually shifted priority to expenditures in the social sectors, which has considerably expanded the availability of basic social infrastructure and amenities, and helped build an educated and healthy population—which has, in turn, helped to promote a responsible and responsive administration. HP has achieved per capita social sector expenditure which is currently more than double the all-States average (Figure 1.3). The initial infrastructure investments have also started yielding dividends in terms of higher growth.

This shift in the state's priorities is reflected in Plan expenditures. Immediately after the formation of the state in 1971, the early Plans allocated less than 20 percent of public expenditure to social sectors—but this more than doubled to about 40 percent during the Tenth Plan (2002–07) period. On the other hand, expenditure on transport and communications, and energy, which collectively accounted for almost 60 percent of the early Plans, has come down to about a third of aggregate expenditure more recently.

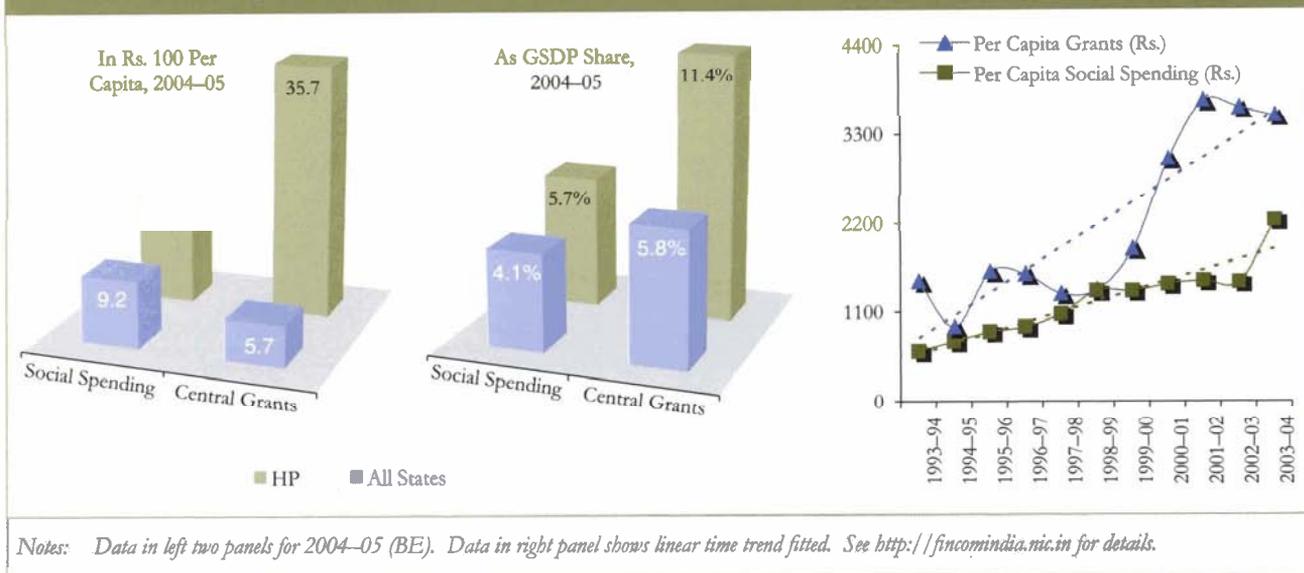
Central grants to HP as a “special category” state are currently above Rs. 3550 per capita—compared to an all-States average of only about 15 percent of that (Figure 1.3). These grants have played a critical role in financing public expenditures, and have allowed the state to overcome its fiscal constraints, and achieve high social sector expenditures. In fact, recent data show that per capita grants—along with per capita social spending—have been rising over time (Figure 1.3). Other central incentives—like central tax sops to attract industries—have contributed to recent growth in the secondary and tertiary sectors.<sup>7</sup> While these special benefits might have contributed to the absence of hard reforms by providing a soft budget constraint

<sup>6</sup> Based on these measures, an *India Today* survey ranks HP as second only to Punjab among Indian states. Please see “The Leaders' Last Hurrah”, September 11, 2006, issue.

<sup>7</sup> See Chapter 3 for a discussion of tax incentives.



Figure 1.3: High Central Grants and Social Spending in HP



to HP, their role in the state's achievements should not be under-valued.

In addition, HP has also been helped by political economy factors and social cohesion. First, the state has consistently supported national political parties, and has aligned with the party in power at the centre. This has possibly contributed to the centre being favorably disposed towards HP's development needs. At the same time, since the 1980s, major national parties have alternated in power in the HP legislature.<sup>8</sup> This voting pattern has likely contributed to the responsiveness of the administration, by preventing the creation of a monolithic power base which a single political party can take for granted as a vote bank. The different state administrations, irrespective of political affiliations, have all had a common focus on social development in HP. Second, the state has benefited from relative political peace and social stability. The absence of insurgency and strife—which has affected states such as those in the north-east and neighboring Jammu and Kashmir—has

helped create an atmosphere where social development has not been constrained.

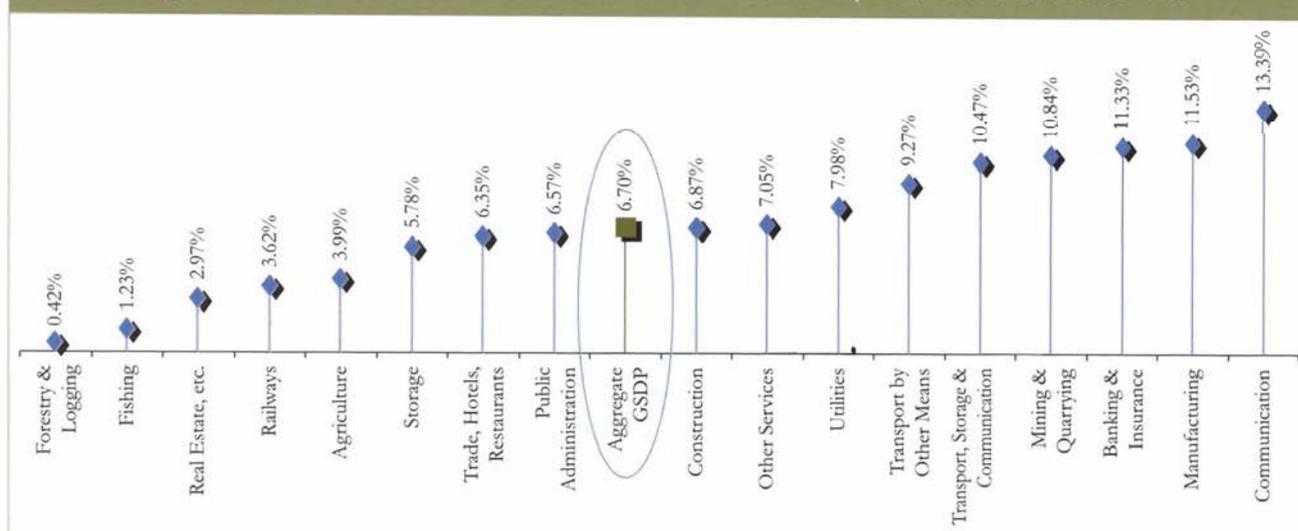
## B. Key Development Priorities in the Medium Term: Consolidation and Inclusion

Looking forward, GoHP appreciates that there is an unfinished agenda in spite of the recent success. Accordingly, the Approach Paper to HP's Eleventh Five Year Plan (2007–12) seeks to achieve the twin objectives of faster growth and inclusive development over the medium term. The articulated Plan objectives are provision of essential social services—especially to disadvantaged groups, increasing farm incomes, developing vital infrastructure, protecting the environment, and improving governance. A vital thrust area identified by GoHP is the need to tackle the unemployment problem, and provide suitable

<sup>8</sup> See [http://www.worldstatesmen.org/India\\_states.html](http://www.worldstatesmen.org/India_states.html).



Figure 1.4: Real Sub-Sectoral Growth Rates in HP, 1993–94 to 2005–06



Notes: Based on data from Department of Economics and Statistics, GoHP; annual growth rates computed by Bank staff.

employment opportunities to the educated youth of the state.

HP's development priorities are a function of its unique socio-economic characteristics. Unlike the states in the plains, GoHP recognizes that growth opportunities lie in some specific sub-sectors where it has natural advantages. Even though human development indicators are among the best in the country, the state appreciates that there room for further progress—and seeks to further improve living standards, especially for disadvantaged sections and remote areas.

### Sustaining and Enhancing Growth Performance

While HP has been growing marginally faster than national averages on aggregate over the last decade, this follows two decades of slower growth—and it may not be at a “steady state” sustainable growth equilibrium as yet. First, there are high potential sectors that could contribute to more rapid growth. In particular, there are sub-sectors like forestry and hospitality that have

grown slower than aggregate GSDP despite the state's natural advantages (Figure 1.4). Second, sub-sectors like manufacturing have been growth drivers in the recent past, helped by historical tax sops and other benefits which have attracted new industries, especially in the districts bordering Punjab and Haryana. It will be important to sustain this good performance, and retain the new industries after the benefits are phased out in 2010. Third, HP still needs to catch up with more developed states like Punjab, Haryana, Gujarat, Tamil Nadu, and Karnataka in terms of per capita income levels.

The government aims to achieve an annual growth rate of 8.5 percent during the Eleventh Plan. In order to achieve this, the state seeks to focus more on capitalizing on its comparative advantage, by increasing the productivity and economic value of its natural assets, and specializing in sectors where it can compete effectively in a globalized economy.

A related issue for the state is to enhance opportunities for productive employment. Though aggregate unemployment rates in HP are lower than national



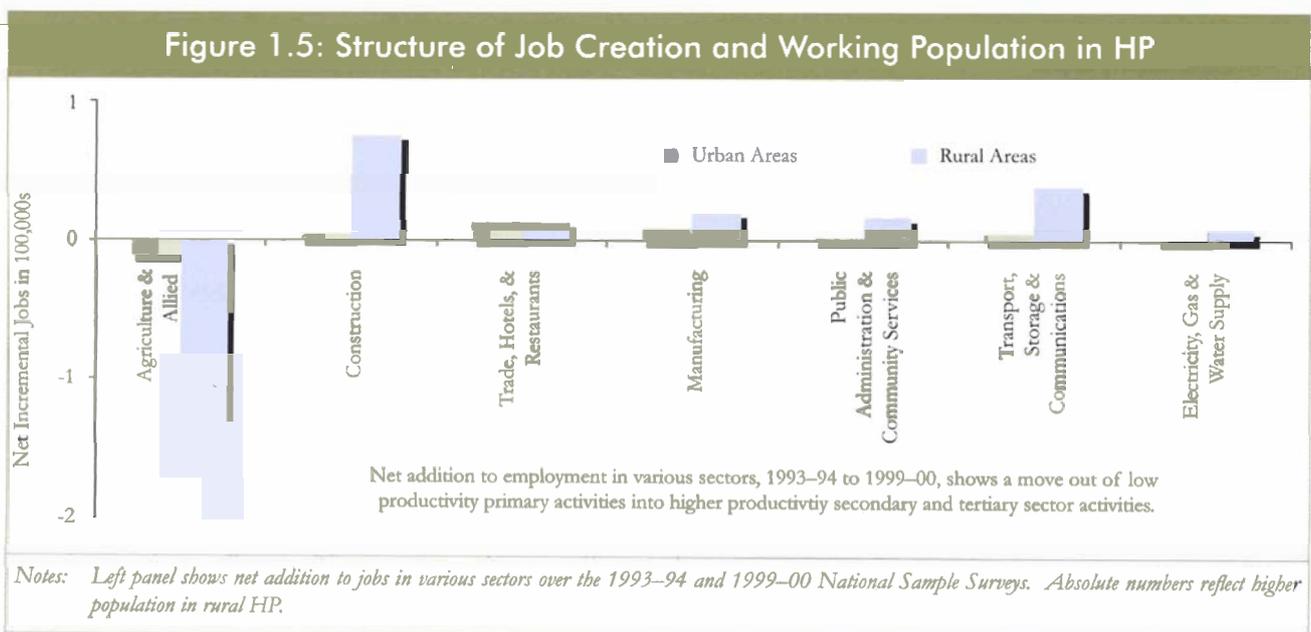
averages, at 2.9 percent compared to 7.3 percent, there is evidence that the productivity of employment may be low.<sup>9</sup> First, despite its declining importance, the primary sector still accounts for almost 70 percent of employment, but generates less than 22 percent of GSDP. Not only are productivity and incomes from this sector low, they are also likely to be more volatile, increasing vulnerability. The dependence on agriculture is especially extreme in the case of rural female workers, 95 percent of whom were employed in the sector in 1999–00. Second, it appears that the high employment figures conceal significant amounts of underemployment or disguised unemployment. In 1999–00, 6.3 percent of rural and 4.4 percent of urban workers reported being available for additional work. Further 5.2 percent workers reported availability for alternative work, suggesting dissatisfaction with their current employment.

There is a need to transition workers out of subsistence agriculture to more productive employment by creating suitable opportunities in the non-farm sector. To some

extent, the transition already seems to be happening, with increasing deployment of incremental workers in construction, manufacturing, and sectors associated with tourism—while agricultural jobs are on the decline (Figure 1.5). The slow pace of the process is, however, troubling. In the rural areas in particular, more jobs are being lost in agriculture than are being created elsewhere. Between 1993–94 and 1999–00, while the working age population in rural areas increased by about 0.46 million, employment stagnated with hardly any net addition. Consequently the unemployment rate in rural HP rose from 1.6 percent to 2.9 percent over the same period. However, the working age population is rising and demand for jobs will continue to rise in the medium term.

### Promoting Inclusive Development and Improving Living Standards

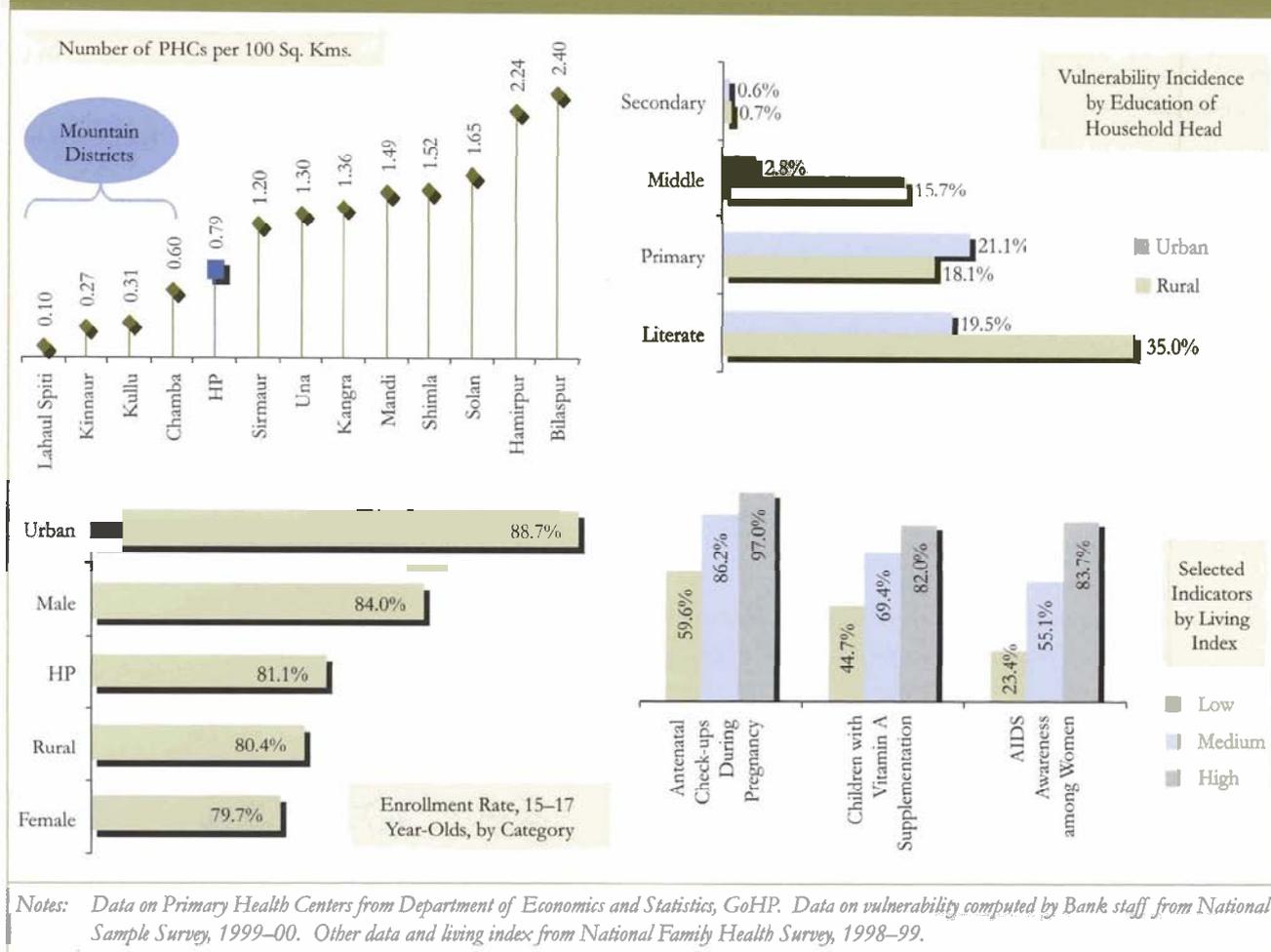
Even though less than 10 percent of the population is classified as poor, HP faces issues in terms of



<sup>9</sup> This is as per 1999–00 National Sample Survey figures.



Figure 1.6: Some Examples of Differential Indicators of Social Outcomes and Access



vulnerability of the population. Absolute poverty is not a major issue by itself. However, vulnerability estimates for the state suggest that the likelihood of households falling into poverty in the near future is higher than the proportion of households currently poor—especially in rural areas. It is estimated that about a fifth of the population could slip into poverty within the next three

years if the state's good economic performance cannot be maintained.<sup>10</sup>

Despite impressive achievements in aggregate social development, there are indications of differential outcomes and access for social, economic, and geographic categories (Figure 1.6). Indicators generally tend to be

<sup>10</sup> See Annex 3 for details. Vulnerability is estimated from National Sample Survey 1999-00 data. The expected future poverty status of a household is obtained by comparing the predicted future per capita consumption with the current poverty line, with predictions based on regressions of consumption expenditure on household characteristics. Vulnerability incidence (i.e., whether or not a household is vulnerable) is obtained by comparing the mean vulnerability (estimated as the probability of being poor at least once in the next years) of the household with a threshold value of 0.50. See Chaudhuri (2000). While this approach has limitations as it is not based on panel data, it does indicate that the state cannot afford to be complacent about its achievements in poverty reduction. The national vulnerability rate (excluding Bihar due to data issues) is 54 percent, compared to 22 percent in HP.



worse for poorer households, women, households with less educated members, households without regular employment, households with high dependency ratios, and remote areas. It is very important to note, however, that these socio-economic differentials tend to be lower than in most other Indian states, and are not always consistently systematic in any one direction.

The state seeks to ensure that its growth strategy does not widen existing inequities. To the extent that household incomes are predictors of selected social outcomes, inclusive growth would, in fact, lead to closing the gap in social outcomes. Recent growth in HP has been associated with declining inequities. For example, the Gini Coefficient for consumption expenditure has declined from 0.27 and 0.47 for rural and urban in 1993–94 to 0.24 and 0.29 respectively in 1999–00. It is important to sustain this performance.

### C. Towards a Development Strategy for the State

HP has several impressive achievements to its credit. Although a “special category” state, it has acquired many of the characteristics of a middle income Indian state. For instance, its per capita GSDP exceeds that of many developed states such as Kerala and Andhra Pradesh. It has grown faster than the national average in recent years, and has achieved levels of social outcomes and infrastructure that are better than in richer states for several indicators.

However, these achievements mask several problems for the state. Unlike the developed states, HP’s achievements have been largely led by the public sector, influenced by its status as a “special category” state which entitles it to liberal central government grants and, more recently, industrial investment incentives. On one hand, the soft budget constraint from a liberal devolution regime, combined with some farsighted planning, has proved beneficial in making HP the leading “special category”

state in India in many respects. Collaterally, benefits from generous transfers and grants from the central government that softened the budget constraint may have held back the implementation of bold fiscal reform initiatives by GoHP and contributed to fiscal indiscipline. This has created other difficulties such as high debt, and, more importantly, a political consensus around the role of the state. It has also resulted in a policy logjam, and excessive reliance on the central government for development—with little policy initiative that can harness the state’s many natural advantages for development.

GoHP recognizes that state-led development has certain limits, and generous financial flows from the central government cannot be assumed indefinitely—especially as HP’s development achievements influence central devolution to redistribute resources progressively to weaker states. The special tax incentives that have promoted industrial growth are also due to be phased out gradually by 2010. At the same time, past state involvement has raised expectations of economic development which could be difficult to fulfill if central support is phased out—unless GoHP undertakes reforms, and devises alternate strategies to move the state from being a provider to a facilitator and regulator. Most fast growing states have embraced this need for reorienting government. HP must undertake the transition to take advantage of new opportunities to tackle the state’s development challenges.

The assessment finds that, in order to realize its development priorities, the state has to overcome several inter-related challenges and come up with a coherent strategy to address them. Despite significant achievements, HP cannot afford to rest on its laurels, and must work towards sustaining and leveraging the gains it has already made.

The key challenge faced by the state at present is insufficient fiscal space to finance the development vision. While there are recent signs of a fiscal recovery, this has to be maintained. Fiscal resources can finance



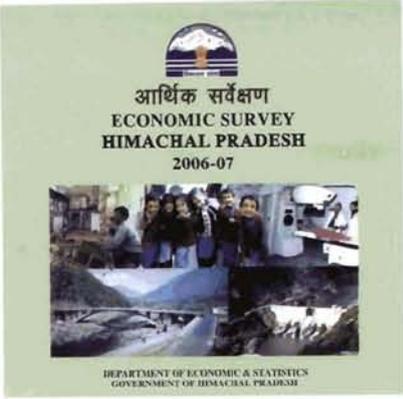
a variety of development priorities—such as critical infrastructure that is more costly to construct than in the plains, investments that can help exploit the untapped potential in sectors in which HP has a comparative advantage, and social sector expenditures to improve delivery of public services and promote inclusive development.

At the same time, in order to realize HP's true development potential, GoHP must provide an enabling policy framework that promotes growth and economic opportunities. Better infrastructure and relevant skills development for the population can reduce constraints to private sector participation, and, in turn, help reduce the populations' current dependence on the public sector for services and employment opportunities—which could lead to a virtuous cycle in terms of freeing up additional fiscal resources. Given that the terrain is unlikely to promote a growth model based on traditional agriculture or heavy industry, opportunities and potential in various

sectors in which the state has a natural comparative advantage—such as tourism and hydropower—need to be leveraged. Despite good objective indicators of human development, there is scope to improve some aspects of public administration and service delivery. It is particularly important for GoHP to protect its environmental wealth while pursuing its development agenda, since much of HP's future growth prospects are critically linked to its natural heritage which is its strength.

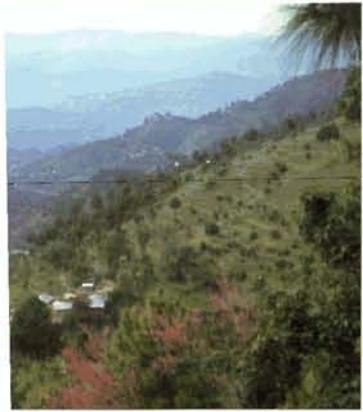
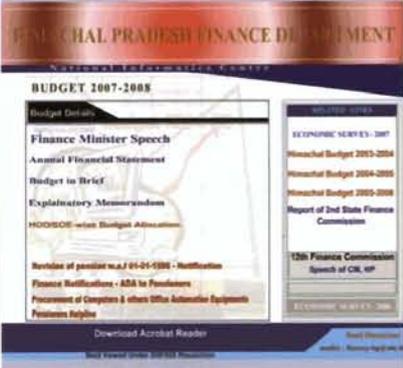
The Report analyzes a number of constraints that require dynamic policy changes, institutional capacity building, private participation, and infrastructure creation. It offers some short and medium terms policy recommendations, based on an evaluation of critical challenges and existing opportunities. Taking the necessary policy measures will put the state on a path towards sustainable development, and help preserve and maintain the state's commendable achievements.

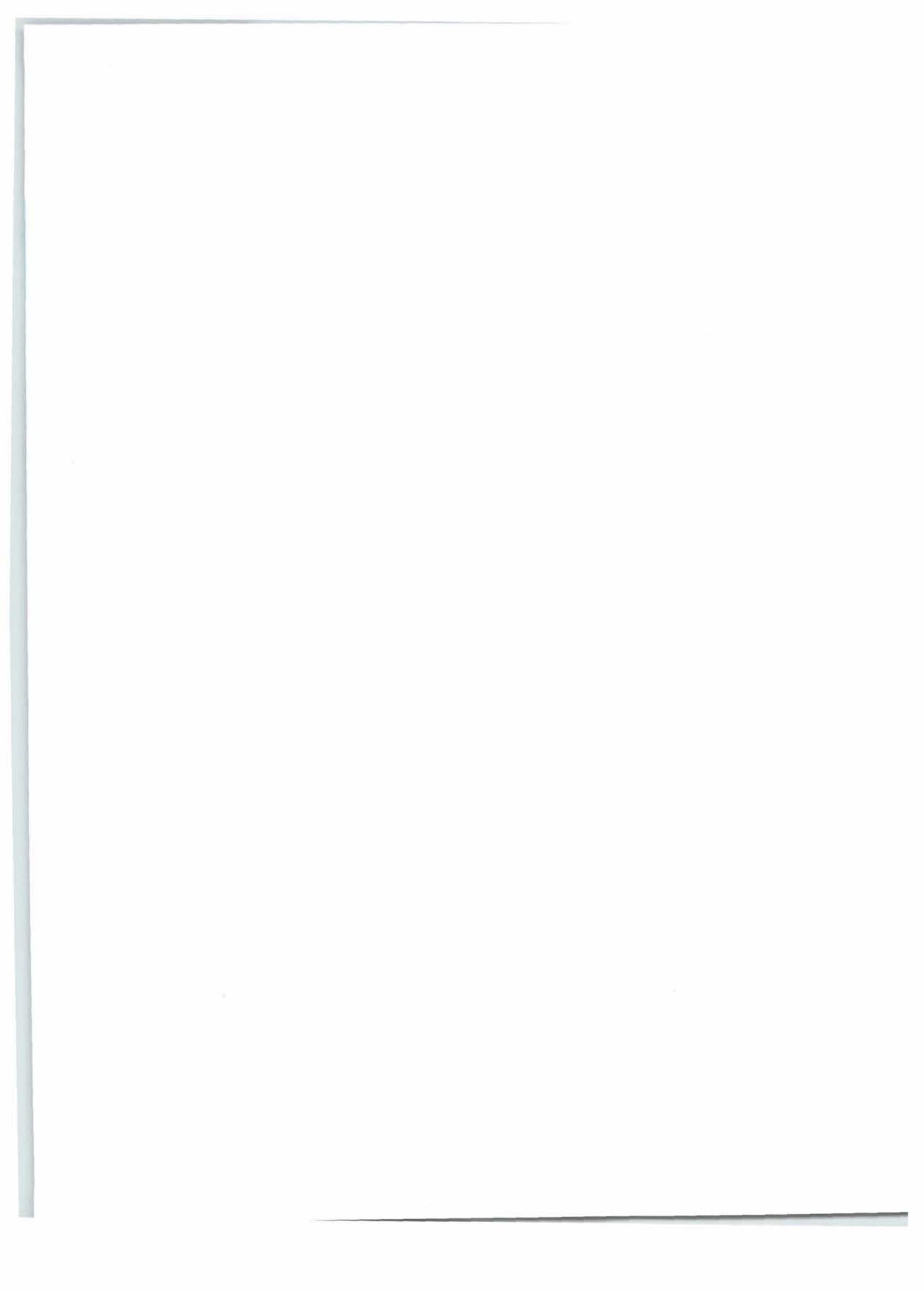




# 02

## Creating Fiscal Space to Realize the State's Development Vision





## Creating Fiscal Space to Realize the State's Development Vision

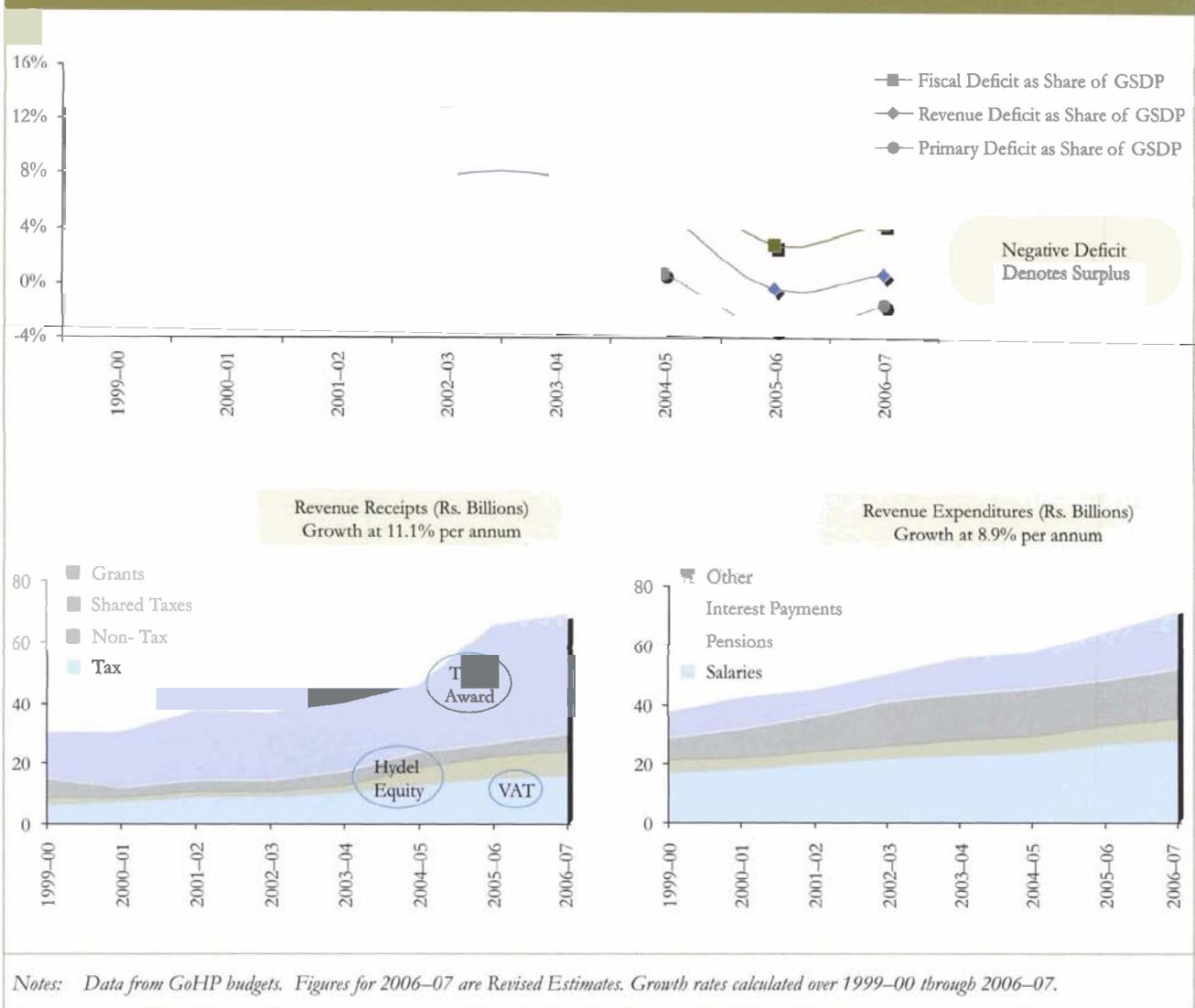
In order to address the state's development challenges, it is important not only to adopt appropriate policies, but also to generate resources to finance investments. HP is a debt-stressed state, with an unsustainably high debt stock of about 74 percent of GSDP (including off-budget borrowing)—largely a result of fiscal distress evidenced in the high fiscal deficits since the mid-1990s. In terms of per capita debt, HP is the second highest in the country. The expenditure composition is rigid, with salaries, pensions, and interest accounting for 70 percent of total expenditure. This provides negligible fiscal space for financing the state's strategic investments. Due to the high debt stock, fiscal policy over the medium term faces the twin challenges of achieving debt sustainability and creation of fiscal space for priority investments, such as in hydropower generation, transport, and social infrastructure to support growth and employment.

Some recent positive developments have led to early signs of a **fiscal turnaround**. First, in 2004–05, own *non-tax revenue* was strengthened by inflows of Rs. 2.85 billion—comprising revenue from the sale of power

(12 percent royalty power) from hydropower projects and equity share power on account of state's 22 percent equity in the Nathpha Jhakri Hydropower project. Second, the introduction of *Value Added Tax* (VAT) resulted in an increase in sales tax revenue by 34 percent (Rs. 1.86 billion) in 2005–06. Third, under the Twelfth Finance Commission's (TFC) award, the state's *non-plan grants* increased 84 percent in 2005–06 (Rs. 14 billion). This was combined with expenditure compression efforts, which reduced total expenditure to GSDP ratio from 32 percent in 2002–03 to 29 percent in 2005–06. This has resulted in a fall in the fiscal deficit to GSDP ratio to 2.8 percent in 2005–06 (Figure 2.1). However, in 2006–07 (RE), the fiscal deficit has gone up to 4.3 percent of GSDP. Consolidating the turnaround requires a sustainable long term fiscal policy. Such a policy must target reduction in the level of debt stock while creating fiscal space for financing the development vision of the state. In this context, the present episode of fiscal correction presents a concrete and promising opportunity to the state government to strengthen its finances robustly.



Figure 2.1: Recent Fiscal Trends in HP



## A. Strengthening Own Revenue Performance

The state's revenue performance has been improving but the process has been slow. HP is highly sensitive to central devolution in the form of grants and shared taxes, and these averaged about 70 percent of GoHP's revenues. However, there has been a recent favorable shift in revenue dependency, as described above, and this needs to be consolidated.

## Measures to Enhance Own Tax Revenues

### *Rationalizing and Adjusting Tax Rates*

HP's aggregate own tax revenue has improved gradually, and, at about 6.2 percent of GSDP, is comparable to the national average of 6.1 percent. However, other states with similar per capita incomes have higher own tax to GSDP ratio—like Punjab with 8.3 percent or Karnataka with 12 percent in 2005-06. The state could look at the following measures to improve performance.



- **Sales tax**—largely VAT—is the main source of own taxes, but gains from this may be drying out following two years of implementation. The yield from this tax is also lower than the national average of 3.7 percent of GDP. Given that the VAT has completed nearly two years in the state, it may be useful for GoHP to consider an external evaluation of VAT implementation with a view to streamlining and strengthening VAT administration, making the department taxpayer friendly, and preventing tax fraud. This evaluation could include value chain analysis, VAT assessment, system of refund, use of nationally harmonized definition of goods, fraud risk analysis, VAT threshold limit, etc.
- **Excise duty** on liquor is the second major source of tax revenues, and does better at more than double the national yield. However, the system is presently structured as specific duties classified in eight categories, with sub-categories—making the system complex to administer and open to subjective interpretation of the category of duty to levy. Given the complexity, GoHP could consider steps to switch from a specific to an ad-valorem excise duty structure following the Maharashtra example, and simplify the license fee structure for alcohol vending.
- **Stamp and registration duties**, at 0.3 percent of GSDP, are almost half the national yield of 0.6 percent of GDP—but downward revision in stamp duty has resulted in a small increase in revenue.<sup>11</sup> In HP, these charges could potentially amount to a tenth of property value, higher than in most other states.<sup>12</sup> GoHP could undertake an analysis of stamp duty evasion schemes and their revenue impact to prepare for a more fundamental reform of the stamp duty system, and reduce registration fees on par with other states.
- The **motor vehicles tax** in HP is lower than in other states, and could be a source of lost revenue.<sup>13</sup> GoHP could: (i) conduct a comprehensive study of the revenue implication of the current motor vehicle tax regime, and raise the lifetime tax rate gradually as in other states; (ii) periodically revise the specific rates of the motor vehicle tax which have not been revised since 2001; (iii) revamp fees for permits, registration, licenses, and fitness certificates, and increasing revenue collection from road tolls. A 'green tax' on older and more polluting vehicles could also be introduced.
- Taxes on **goods and passengers** collected by the Excise and Taxation Department have declined from 20 percent of tax revenues in the late 1990s to about 3 percent currently—following the introduction of a special roads tax for transport vehicles. The state could consider merging the goods and passengers tax with the special roads tax.
- HP has an **electricity duty** at the flat rate of 6 paise per unit consumed in bulk use and 33 paise per unit on consumption by industries, as last revised in the 2005–06 Budget. The tax take from this source has been uneven over the years and constituted below 4 percent of tax revenue in 2005–06. The electricity duty could be folded into VAT, given low and uneven intake from it.
- In addition, the state levies a number of **minor taxes** such as land revenue, and there are administrative costs involved. The state needs to study the administrative cost of minor taxes and either devolve them to local bodies or withdraw

<sup>11</sup> As part of the fiscal reform programme, stamp duties were reduced to a uniform 8 percent of sale deed in April 2005 from 12 percent (effective from April 24, 1991). This led to a small increase in revenue from this source.

<sup>12</sup> In addition to the 8 percent stamp duty, registration fee under the Indian Registration Act, 1908, as applicable to HP, at the rate of 2 percent on the value of consideration, subject to a maximum of Rs.25, 000 is also levied. Most states levy only 1 percent registration fee.

<sup>13</sup> Non-transport vehicles are subject to one time tax, while transport vehicles are subject to an annual tax. In addition, HP levies a special road tax on transport vehicles. The current level of the one time tax is 2 percent on the price of personal vehicles such as cars and 1.5–3 percent on the price of two wheelers. The one time tax is considerably lower than in other states where it could range between 6 percent and 8 percent of the price of the vehicle. Transport vehicles are charged an annual specific tax depending on the nature of the vehicle.



them if the costs of administration do not make them worthwhile.

- HP is one of only five states in India not to have a **professions tax**, and this denotes potential lost revenue<sup>14</sup>. The state could reintroduce this tax. While most states levy, collect, and devolve the tax to local bodies, six states have assigned the tax to municipalities to levy and collect. HP may consider an appropriate model to collect the tax.

### Modernizing Tax Administration

GoHP should also look into modernizing tax administration following international examples. At present, the revenue administration system is somewhat complex, with several revenue-collecting agencies in different departments. The various tax collecting agencies currently report to different Secretaries in the government. There is no comprehensive uniform accountability mechanism, and accountability is based exclusively on collection results. The key Excise and Taxation Department has a territorial rather than functional organization structure, and requires more qualified and senior staff.

Overall responsibility for revenue collection could be streamlined and consolidated in **one dedicated collection agency**. This agency would have the overall responsibility for managing compliance and implementing the tax system. The Excise and Taxation Department could be the basis for a unified tax collection system in HP. Other revenue-collecting agencies would then concentrate on their core, non-collection functions. Such reform requires careful preparation, however. As preparatory and more short-term measures, assessment and collection functions of different departments can be co-located (e.g., by creating integrated check posts), and procedures can be harmonized (e.g., by unifying real property valuation for stamp duty and urban land tax purposes).

**Reporting and accountability** mechanisms could be improved. A modernized tax administration should report on a regular basis to a government Secretary in charge of revenue collection. Performance measures should reflect broader reform priorities and not focus exclusively on collection results. For example, important measures of the performance of the tax administration could include the quality of services and information provided to taxpayers, a broadening of the tax net, or reduction of the time required for registration of a business for tax purposes.

The **capacity and organizational structure** of the Excise and Taxation Department needs to be strengthened and streamlined before it can be charged with additional assessment and collection tasks. Moving from a *territorial to a functional structure* in the Excise and Taxation Department is probably the single most important initiative the government can take to reform tax administration. The reorganization would have to be carried out at the headquarters and territorial levels. It would create the necessary organizational basis for separating and strengthening the key tax administration functions of registration, audit, collection, and taxpayer services. The *human resource situation* of the Department also needs to be addressed—since a professional and specialized tax administration requires an appropriate level of highly qualified staff. This indicates a need for increasing the percentage of senior staff at officer level in the administration.

The **planning process** must be strengthened. Modern revenue administrations in developed and developing countries have introduced regular, multi-year, strategic planning processes, often spanning a five-year period. These define the mission and vision of the revenue administration, identify the challenges to address in the planning period, as well as reform priorities. The strategic plan is then translated into annual business plans for the tax administration. Introducing regular

<sup>14</sup> The others are Arunachal Pradesh, Punjab, Jammu and Kashmir, and Jharkhand.



Table 2.1: User Charges in HP compared to Other States

<i>Health User Charges in Rs.</i>					
Services	HP	Haryana	Sikkim	Assam	Andhra Pradesh
OPD Fees	Free	5	NA	5	2
Blood Culture Test	100	70	100	50	NA
ECG	30	25	40	150	30
X-Ray(Chest)	15	50	30	50	40
Ultra Sound	15	70	200	250	75
<i>Average Annual Fees in Education in Rs.</i>					
Services	HP	Uttaranchal	Sikkim	Punjab	Karnataka
Girls' Higher Secondary Education	Free	Free	Free	Free	Free
Boys' Higher Secondary Education	180	240	Free	120	200

*Notes: From government websites and www.inidastat.com*

multi-year strategic planning for tax administration reform in HP could be beneficial.

## Measures to Enhance Own Non-Tax Revenues

HP's non-tax revenue averaged below 2 percent of GSDP in the 1990s, but there was a shift from 2004–05 due to receipts from sale of royalty power that the state is eligible for from all new projects under the state's hydropower policy<sup>15</sup>. The state also gets 22 percent of power generated at generation cost from the Nathpa Jhakri project in proportion to its equity share in that project.<sup>16</sup> In order to enhance revenues from this source, the state has two options. Under the first option, the state allows private participation under a transparent investment policy and regulatory environment and enjoys the benefit of 12 percent royalty power. Under the second, the state could invest jointly with other partners and get a share of the power generated proportional to

equity invested, in addition to the royalty power. The latter course would require the creation of fiscal space for the necessary investment, besides bearing the risk of project completion.

The story on user charges is mixed. *Irrigation charges* were revised in June 2005. Although the stated policy is to revise irrigation and water charges by 10 percent annually, this is not regularly implemented. In a retrograde move in May 2003, GoHP abolished user charges levied in *hospitals and health institutions* and restored the position of tariffs as on March 24, 1998. The Rogi Kalyan Samitis, set up in various hospitals to provide a measure of autonomy to hospitals to determine user fees, have also been abolished. A review of health and higher education charges levied in HP and a few peer group states chosen on per capita and similar status basis (hill states) shows that there may be scope for restructuring user charges (Table 2.1). Of importance is a detailed analysis of the cost of providing different services, user charge comparisons

<sup>15</sup> The state gets free royalty power from eight projects: Bairasual, Chamera I and II, Shaman, RSD, Malana, Baspa II and Nathpa Jhakri.

<sup>16</sup> In 2005–06, proceeds from the sale of power amounted to Rs. 2.47 billion. The receipt projected in 2006–07 is even larger at Rs. 5.46 billion.



across states, and public consultations for regular revision of tariff.

In order to enhance non-tax revenue from user charges, the state could consider establishment of a 'Public Tariff Commission' for various services like transport, education, health, water, and irrigation to depoliticize user charge determination. This measure was announced in the 2005–06 Budget Speech. An independent Commission should be established at the earliest to provide an assessment of user costs for various services, carry out public consultations on tariff revision, and advice government on tariff fixation.

## B. Controlling Expenditure and Improving its Composition

Total expenditure as a share of GSDP has declined in recent years from 32 percent in 2002–03 to about 29 percent of GSDP in 2005–06, but expenditure composition needs to improve. The decline in expenditure has contributed to encouraging improvement in the fiscal balance. However, contractual expenditures—

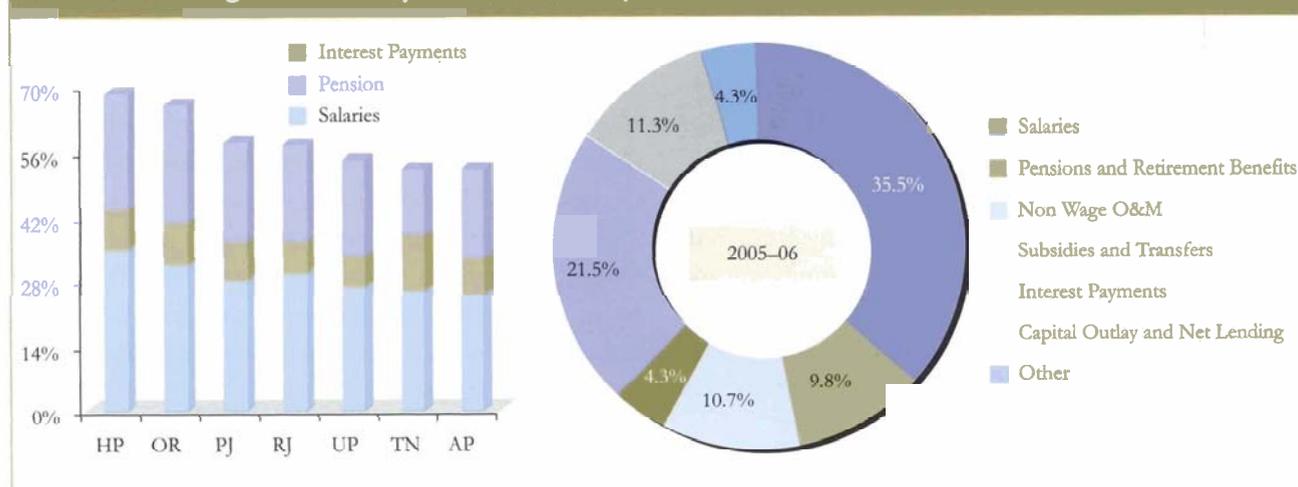
salaries, pensions, and interest—account for 70 percent of expenditure, which is higher than in most other states (Figure 2.2). Capital expenditure and non-wage O&M have together declined from over 40 percent of expenditure in the mid-1990s to only about a fifth at present. This concern is appropriately reflected in the 2005–06 Budget Speech which calls for expenditure prioritization to improve outcomes.

### Revenue Expenditure

#### Wages and Salaries

Salaries are an important component of expenditure in the state, accounting for about a third of expenditures according to 2006–07 (RE). This results largely from the liberal employment policy and a wage regime that historically has followed the salary structure of Punjab. Despite the high staffing ratio, this has not restrained GoHP from regularizing temporary workers or creating new positions or replicating wage indexation announced by GoI for its civil servants. Although a hiring freeze is in place, examples suggest that it has not been seriously and consistently implemented. For

Figure 2.2: Expenditure Composition in HP and Selected States



Notes: Data in left panel for 2004–05. All data are as percentage of expenditure.



instance, the 2006–07 budget announced a liberal policy of *regularizing* all daily wagers completing 8 years of service against existing positions or by creating new positions on merit. The new policy extended a policy whose earlier cutoff was March 31, 2000. The expected number of beneficiaries from this is 15,000 and the expected expenditure is Rs. 550 million. In 2005–06, GoHP merged, with effect from April 1, 2004, 50 percent of the separate wage indexed component of pay (Dearness Allowance) with basic pay scales at a cost of Rs. 1500 million. In the medium term, a fiscal adjustment risk is the implementation of the Sixth Central Pay Commission's award when it is announced. As it is, HP is unlikely to meet the criteria for salaries recommended by the TFC.<sup>17</sup>

The government requires an effective wage and hiring policy that is consistent with fiscal sustainability.<sup>18</sup> Elements of such a policy should include reviewing staffing norms for various departments, identification of vacant positions and implementing a hiring freeze against vacant positions except in critical areas, reallocation/closures of vacant posts, budgeting only against staffed positions, reviewing the policy for regularization of work charged, daily work charged and temporary employees, Pay Commission implementation, delinking automatic inflation indexation of salaries to central announcements, reviewing system of grants in aid to educational institutions, etc.

### Pensions and Retirement Benefits

Pensions are an increasing fiscal burden, having risen from about 8 percent of expenditure in 2002–03 to over 9 percent at present. In August 2006, the state

introduced a Contributory Pension scheme for new employees joining service after May 15, 2003, and it follows the GoI pattern of contributions.<sup>19</sup> However, the impact of the new pension scheme will be felt over the longer term, and, till then, the state will have to contend with pension expenditure under the Defined Benefit scheme for employees hired prior to May 15, 2003. Since provisions under the Defined Benefit systems are totally unfunded, all recurring costs have to be paid out of revenue, and this will have fiscal implications. Moreover, there has been ad hoc wage indexation historically, with pensions for retired workers adjusted on the basis of revised wages of the last post held prior to retirement, in line with recommendations from the Pay Commission approximately every ten years. Given that the primary purpose of any post-retirement indexation is to preserve the real value of pensions, some contractual safeguard is needed to confirm that post-retirement indexation will only be provided for price changes, and that GoHP will not grant wage indexation any time in the future.

In this area, the state could: (i) undertake and complete *pension projections* for government and public sector agencies and begin annual budgeting on actuarial basis;<sup>20</sup> (ii) *index pensions* automatically to price increases instead of ad hoc wage indexation every ten years through the Pay Commission; (iii) consider the scope for expanding the defined Contributory pension fund pool through voluntary or mandatory *switching options*, and especially entice younger workers who joined before May 15, 2003 to switch to the newly introduced scheme; and (iv) introduce *contributory pension schemes* for new employees in public sector corporations, boards, universities, local bodies, etc.

<sup>17</sup> The Twelfth Finance Commission has recommended that salaries must not be more than 35 percent of total revenue expenditure net of interest and pensions. HP is projected at around 58.5 percent in 2008–09.

<sup>18</sup> See Chapter 5 for staffing related issues.

<sup>19</sup> The employee contributes 10 percent of Basic Pay and Dearness Allowance towards his pension benefits and the state matches the contribution.

<sup>20</sup> This has been under consideration from 2004, with World Bank assistance. The exercise has not been completed and will need to be expanded to cover Statutory Boards, Corporations, Universities and aided institutions and Local Bodies from wherein GoHP could experience 'moral hazard' as these agencies are closely linked with the Government and follow the Government's pension rules. Knowing future pension liabilities is critical to plan for long-term fiscal sustainability because of the current practice of ad hoc incremental budgeting to forecast pension expenditure.



## Subsidies and Transfers

Subsidies and transfers account for about 7 percent of total expenditure, up from 6 percent in 2003–04. Two large elements determine the level of explicit subsidies: power and transport subsidies. First, GoHP subsidized the *Himachal Pradesh Electricity Board* (HPSEB) Rs. 500 million in 2005–06 and is providing the utility Rs. 2448.7 million in 2006–07.<sup>21</sup> Although relatively small compared to other states, these are important financial resource in HP's context and can be put to better use. The economic basis to the state's decision to maintain the power tariff that existed prior to the 2005 order of the Himachal Pradesh Electricity Regulatory Commission (HPERC) is unclear.<sup>22</sup> The *Himachal Road Transport Corporation* (HRTC) is another entity that received an annual subsidy of about Rs. 480 million over the last three years.<sup>23</sup> Bus fares have not been revised since 1999.<sup>24</sup> The 2005–06 Budget suggests a time frame of 4–5 years for HRTC to financially break even, but the turnaround plan is unclear at the moment.

In this area, the state could consider: (i) reducing the *power subsidy*, and delinking the subsidy from the power tariff; (ii) preparing and implementing a *turnaround plan for HRTC*, which is an important consumer of subsidies; (iii) appointing and activating a *Committee of Experts* to present a roadmap for subsidy containment and a gradual phase out of non-merit subsidies, as announced in the 2005–06 Budget; and (iv) preparing an *annual report* on explicit and implicit subsidies which would add to fiscal transparency, result in public debate, and help create a climate for better targeting, and also support the Public Tariff Commission in determining user charges.

## Interest Payments

The high debt stock has resulted in the share of interest expenditure in total expenditure doubling from 13 percent in the early 1990s to 26 percent in 2004–05. HP, like other states, has been a beneficiary of the debt swap, interest reset, and debt prepayment schemes that GoI operated between 2002–03 and 2004–05.<sup>25</sup> By enacting the Himachal Pradesh Fiscal Responsibility and Budget Management Act (FRBM) in 2005, the state got access to the GoI debt relief scheme structured by the TFC. Under the scheme, Rs. 8.24 billion of GoI loans were restructured, carrying an interest rate of 7.5 percent repayable over 20 years. GoHP will, as a consequence, benefit from a reduction in interest expenditure to the extent of Rs. 1.35 billion over the period 2005–06 to 2009–10 on its outstanding GoI loans. In addition, if the state is able to stay on the fiscal consolidation path and achieve the level of annual adjustment in the revenue deficit as recommended by the TFC, Rs. 0.41 billion in annual repayment of GoI loans would be written-off for five years. However, these measures must be supplemented by aggressive measures to reduce annual borrowing and restructure high cost debt.

## Non Wage Operation and Maintenance

Expenditure on non-wage O&M as share of total expenditure virtually halved between the beginning of the 1990s and 2004–05, going from 22 percent to 10 percent. Non-maintenance of assets will ultimately result in poor service delivery and higher costs of replacement. There are encouraging indications of intent in the

<sup>21</sup> These figures need to be reconfirmed with GoHP.

<sup>22</sup> Subsidies will affect the commercial discipline in HPSEB by not making it responsible for its revenue. In addition, the benefit, productivity, and targeting of the subsidy is at best uncertain. Even if the subsidy is to be provided such subsidy should be direct and transparent and not use the power tariff as a subsidy instrument.

<sup>23</sup> HRTC provides free travel to handicapped, press correspondents, public and former public representatives, freedom fighters, national awardees, war widows, and gallantry award winners. Students and government employees get concessional travel, as do police officials and jail wardens.

<sup>24</sup> Occasionally, HRTC also requires other fiscal support from on and off-budget sources. For instance, in 2005–06 the HRTC was provided an off-budget loan of Rs. 680 million through the Himachal Pradesh Infrastructure Development Board to pay the Provident Fund liabilities of the Corporation. The Corporation with an operating ratio of 1.2 is unable to meet its operating costs. In comparison with Punjab, Karnataka, Rajasthan and Maharashtra state owned transport utilities, Himachal and Punjab had operating ratios (operating costs to operating revenue) over 1. Others had operating ratio of 0.8.

<sup>25</sup> Under the arrangement, the state restructured its debt portfolio with lower cost borrowing to the extent of Rs. 35 billion, saving interest expenditure of about Rs. 1.50 billion per annum. The carrying cost of debt therefore declined from 11.6 percent of on budget debt stock in 2001–02 to 8.3 percent in 2005–06.



2005–06 Budget speech, and earmarked allocations from the TFC for maintenance of roads, buildings, and forests will see **higher expenditure in this area.**

A more systematic approach would focus on development of maintenance plans for fixed assets such as roads, buildings, and equipment, and fully budget for these annually. In other sectors, assessment of service delivery gaps in critical areas such as in health, education, agriculture, police, or the judiciary should drive resource allocation. Since the axe of expenditure typically falls on maintenance heads in favor of salary heads, some measures to prevent this may be necessary. There could be efforts to: (i) separate and protect the salary budget for an agreed staffing plan including temporaries (rather than posts); (ii) discourage reallocation from non-salary

heads; (iii) release resources according to the working season in some departments; and (iv) expenditure allocation according to service delivery norms. This will be critical to the achievement of output under the new performance measurement system that GoHP wants to put in place from this year. (Box 2.1).

## Capital Expenditure

HP appears to incur higher capital expenditure as proportion of GSDP than other states, partly on account of: (i) lower GSDP and higher share of Centrally Sponsored Schemes (CSS) that are determined on normative principles; and (ii) higher cost of provision because of the difficult terrain and remoteness. However, in recent years, capital

### Box 2.1: Essential Ingredients of Performance Budgeting

Four requisites for performance budgeting systems are:

- A framework of strategy, priorities, and objectives covering public expenditure;
- Performance criteria for efficiency, effectiveness, impact which are regularly monitored;
- Annual reports of inputs and outcomes informing budget decisions;
- Programme budgeting with allocations based on performance and desired results.

Additionally, it is important to use feedback from monitoring and evaluation to use budgeted resources more efficiently.

#### Experience from Singapore and Malaysia

Singapore and Malaysia have pioneered performance budgeting in Asia. In Singapore, performance budgeting was first introduced in the 1970s. This was complemented in 1989 by the delegation of authority to ministries to manage their budgets without referring expenditure decisions to the Ministry of Finance and, in 1991, by the introduction of a computer-based management accounting and information system permitting accrual accounting. This was followed by the launch of budgeting for results. The features of the system are:

- The use, for all programmes, of performance indicators and targets—covering inputs, costs and activity levels, outputs and outcomes;
- Conversion of programme cost centres into autonomous agencies—subject to output based budgeting with flexibility in resource deployment;
- Performance incentives in the form of the right to retain half of the unbudgeted efficiency gains;
- Zero based value for money audits of expenditure programmes by the Auditor General's office.

Malaysia's modified budgetary system built on the same base of programme and performance budgeting used in Singapore, and introduced greater fiscal certainty for planning purposes, devolution of financial responsibility, programme agreements with results orientation, and cycles of programme performance reviews. The Malaysian budget process is in two parts: first, an examination of performance achievable with a 'base' budget with unchanged policies, and then the performance and expenditure effects of new policies.



### Box 2.2: Zero-Based Investment Review in Orissa

Several infrastructure projects taken up by the Orissa government were languishing due to lack of monitoring and effective implementation. Consequently, the government, in 2002–03, launched an exercise called Zero Based Investment Review (ZBI) led by a high-powered committee headed by the Chief Secretary. The ZBI review required each department to place the projects under four categories: (i) full funding for fast track completion; (ii) funding on slower track for the present, which could graduate to fast-track in the future; (iii) minimal funding until redesign or restructuring; and (iv) scrap or shelve indefinitely.

While in the first phase, the review was limited to projects/schemes costing Rs. 40 million and above, and, in 2004–05 (second phase), projects costing Rs. 10 million and above were also taken up for completion.

During the last four years of implementation of the scheme, out of 257 identified projects, as many as 90 projects have been completed up to December 2005. Year wise allocation of budget and project completion details is given in the table below.

Year	Budget Estimate (Rs. Millions)	No. of Projects Identified	No. of Projects Completed
2002–03	8.93	41	17
2003–04	19.27	60	24
2004–05	13.81	41	19
2005–06	18.29	115	30
<b>Total</b>	<b>60.30</b>	<b>257</b>	<b>90</b>

For timely completion of the identified projects, concerned departments have been allowed to make necessary provision in the budget, and, in case of emergency, have been allowed reallocation of funds within the overall budgetary allocation. The success of this exercise shows that when the total budget allocation is held constant, positive incentives are created for departments to reallocate funds to priority projects rather than hide “white elephants” to protect budgetary resources. Review meetings chaired by the Finance Minister or Finance Secretary are held to oversee the performance of agencies executing the work and enforce terms of the contract.

expenditure as a share of GSDP has declined to about half its value in 1990–91. The emphasis on the social sector has expanded current expenditure at the expense of capital expenditure.<sup>26</sup> As the fiscal deficit expanded, capital expenditure either shrank or remained constant (Figure 2.1). This suggests that most of the incremental borrowing was used to finance the current deficit.

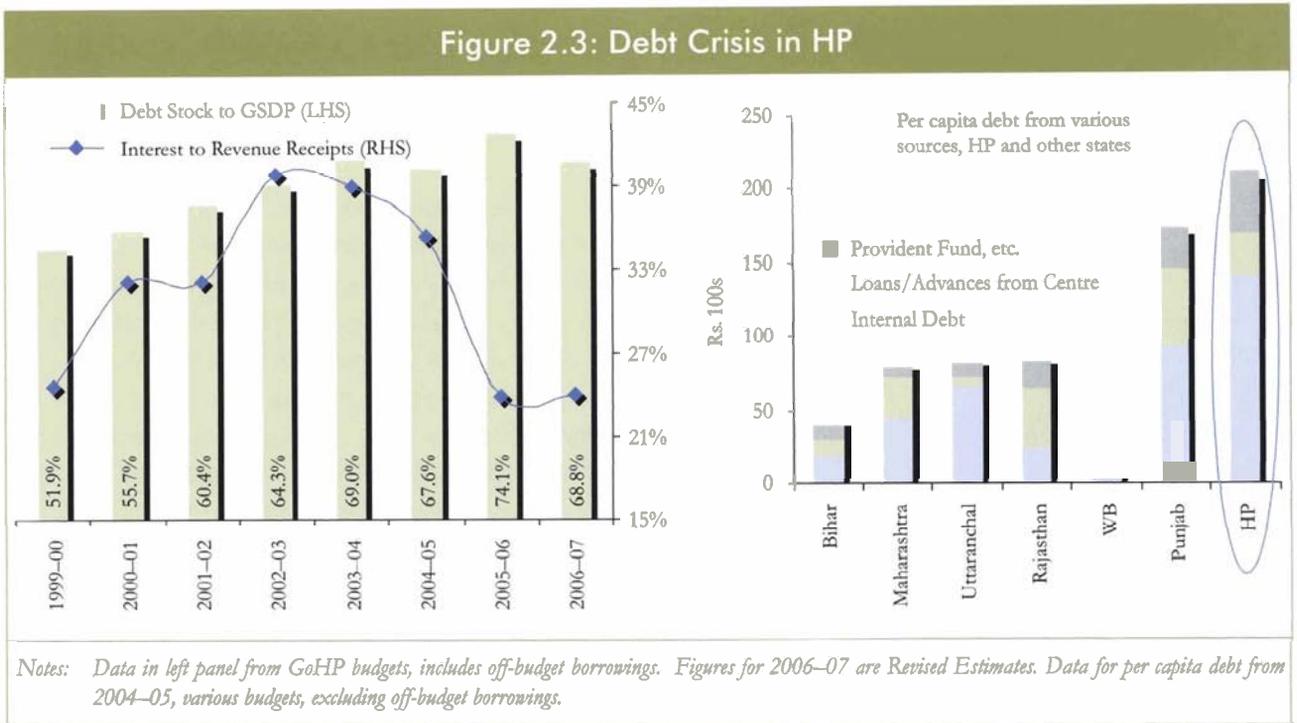
Increasing capital expenditure to meet the state’s infrastructure demand is constrained by the availability of fiscal space, and GoHP got around this after the mid-1990s by borrowing off-budget for supporting infrastructure investments and for financing the budgetary deficit. Although the state has now declared that there will be no off-budget borrowings, GoHP

expects to borrow off-budget to finance its hydropower energy investments under the Eleventh Five Year Plan. Off-budget borrowing in the absence of fiscal space will result in fiscal crisis and loss of creditworthiness. They are also subject to lesser scrutiny and lower accountability. Going forward all capital investments to be supported by GoHP must be budgeted for.

The fiscal strategy of the state must focus on the creation of budgetary fiscal space for priority investment. To enable this, expenditure prioritization is necessary along with restructuring. First, GoHP can follow up on its expressed intention in its 2005–06 Budget to *rationalize and restructure schemes* that have lost their relevance (Box 2.2). Second, the fiscal gains from

<sup>26</sup> GoHP kept a substantial amount of committed expenditure on salaries, pensions, and maintenance under the Plan instead of transferring the expenditure to non-plan heads at the end of the Plan period. This artificially inflated Plan size. Over 2003–04 and 2004–05, the government transferred Rs. 10.21 billion (such liabilities at the end of 2001–02) to non-plan heads of expenditure. This reduced the annual Plan size, but most of it is now investment.





such rationalization may be budgeted on infrastructure projects that are ‘last mile’ in nature, and can be completed with some additional resources. The focus should be on completing on going projects. Third, projects that are going to see *little allocation* and are accommodated for considerations other than economic should not be included in the budget. A number of such projects with meager allocations can together appropriate a visible amount of resources that could be better spent.

### C. Managing Debt and Contingent Liabilities

The most visible aspect of GoHP’s fiscal problems is the high debt to GSDP ratio of about 74 percent including off-budget borrowings, and the high debt per capita (Figure 2.3). The debt is unsustainable and higher

than the average for Indian states of about a quarter of GSDP. GoI guidelines classify HP as debt stressed.<sup>27</sup> Breakdown of debt shows that 77 percent is relatively expensive internal debt comprising small savings loans, financial institution borrowings, off-budget borrowings, etc. About 6 percent was sourced from the Central Government and 17 percent was from Insurance and Provident Funds. The state has taken advantage of opportunities to prepay, restructure at lower interest rates, and swap debt, as described earlier. High cost loans (carrying coupon rates 10 percent and above) constitute almost a fifth of the outstanding debt stock of Rs. 188 billion as on March 31, 2006. Approximately 45 percent of this stock is up for repayment over the next five years, presenting a good opportunity to the state for restructuring high cost debt.

A debt sustainability analysis shows that even under steady state conditions of the baseline, debt to GSDP

<sup>27</sup> Under GoI’s criterion, any state with an interest to revenue receipts ratio over 20 percent is debt stressed. HP had a ratio of 24 percent in 2005-06.



will decline to 35 percent at best in the next fifteen years.<sup>28</sup> This will still be higher than national averages.

Contingent liabilities in the form of outstanding guaranteed borrowings by state-owned Public Sector Enterprises (PSEs) after adjusting for off-budget debt (Rs. 25 billion) was about Rs. 36 billion—or about 14 percent of GSDP as on March 31, 2006.<sup>29</sup> GoHP also carries significant fiscal risks from the losses incurred by PSEs, with accumulated loss of these enterprises being about 4 percent of 2004–05 GSDP. Other forms of financial support in the form of grants/subsidies, equity, loans, and waiver of dues amounted to about Rs. 1 billion, or 0.5 percent of 2004–05 GSDP. The HP FRBM makes it mandatory to progressively reduce outstanding guarantees on long term debt, until outstanding risk weighted guarantees can be capped at 80 percent of total revenue receipts in the preceding year. However, GoHP does not report risk weighted guarantees although the law requires it.<sup>30</sup> Risk weighted guarantees will be substantially lower. In that case, the FRBM target for risk weighted guarantees is too liberal.

As an institutional mechanism, GoHP must have an independent system—which is currently not on file—that considers the following questions before incurring any form of contingent risks:

- Does the Guarantee meet policy objectives? Should the government be involved?
- What form of government involvement would be most efficient? This could take the forms of deregulation, subsidy, contingent support, etc.
- Is the programme designed to cover only justifiable risks and minimize moral hazard—like risk sharing with financing institutions for instance?
- What is the most likely and maximum likely fiscal cost?

- What are the implications for the medium term fiscal outlook? Is this effective in the context of policy priorities and budget allocations?
- Is efficiency being furthered?

The state has already taken an important first step in making it **mandatory to report** under the FRBM a Budgetary statement that presents ‘contingent liabilities arising out of borrowings by PSEs and Special Purpose Vehicles and other equivalent instruments where liability for repayment is on the state government, all claims and commitments made by the state government having potential budgetary implications’. Expanding the form of the statement to present a report on the lines suggested above will result in improving fiscal transparency and bring greater legislative and public (market) scrutiny to the process.

As a rule, GoHP should also minimize the issuance of **implicit guarantees**. Automatic guarantees must be avoided. This becomes important as GoHP increasingly considers Public Private Partnerships (PPPs) for developing infrastructure and providing services that demand government support. Where obligations are already incurred, disclosing, budgeting, and accounting for the potential costs are important for fiscal transparency. Allied to this is the need for a system that will monitor and report contingent liabilities, and regularly update risk analysis—both quantitative and qualitative analysis—and assess the expected fiscal pressures.

## D. Refining Medium Term Fiscal Projections

The state has produced Medium Term Fiscal Projections (MTFP) that were tabled along with the Budget for

<sup>28</sup> See Annex 5 for debt sustainability analysis with the new revised MTFP.

<sup>29</sup> See Annex 6 for details.

<sup>30</sup> Guarantees amounted to 74 percent of 2004–05 revenue.



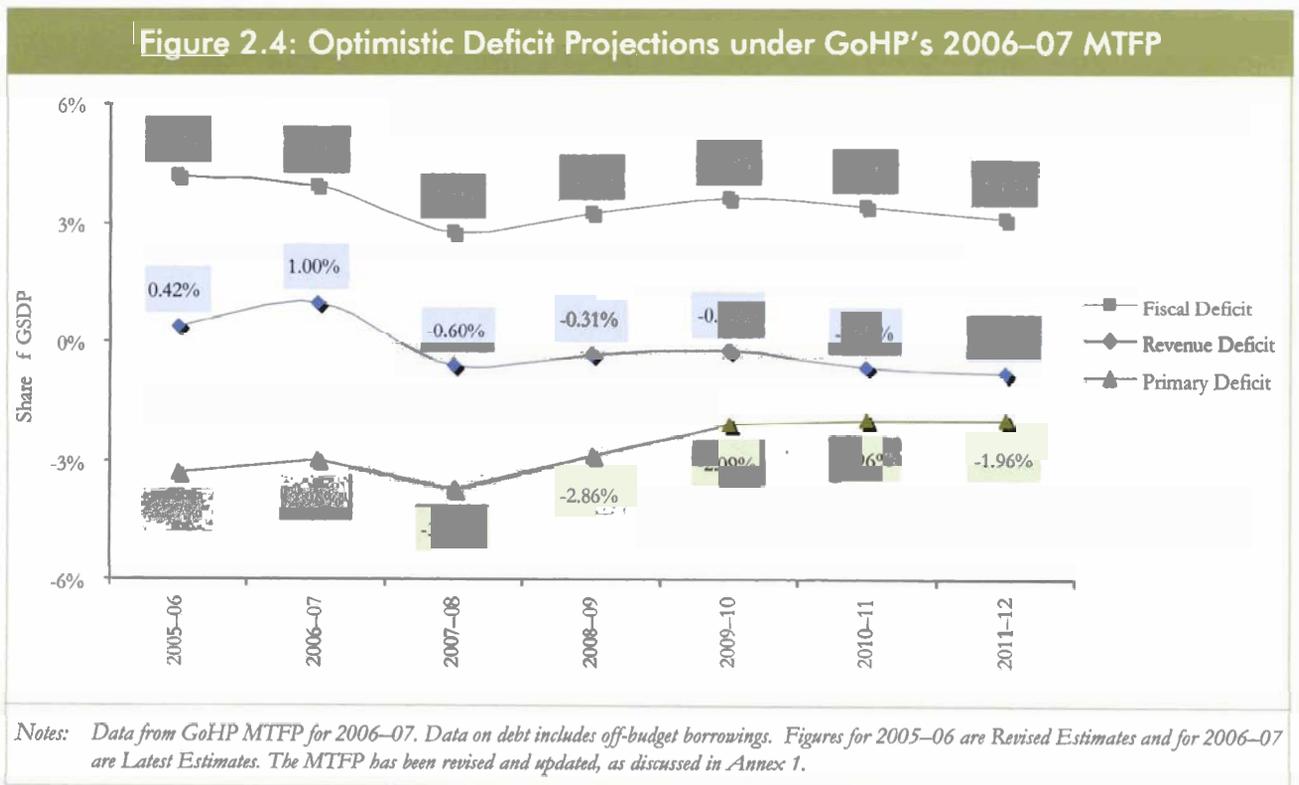
2006–07.<sup>31</sup> The projections have been revised to incorporate Eleventh Plan targets, but are based on some optimistic assumptions (Figure 2.4).

The 2006–07 MTFP requires refinement to be more realistic and reflective of GoHP's vision for the state. First, the projections do not have a clear *policy basis*, and are incremental, making it hard to understand the underlying assumptions. Second, they do not fully factor the *impact of future developments* on which the government has already taken a stance or has some information—such as impact of the Sixth Central Pay Commission, hiring policy, hydropower investment, debt write-off, etc. Finally, the projections do not reflect sufficient change in *expenditure composition* to project a fiscal reform story, and reflect a 'business as usual scenario'. In particular, on the

revenue side, there appears to be a disconnect between growth assumptions, tax buoyancy, and projected tax revenue, while user charges are largely neglected as a revenue source. On the expenditure side, the projections appear ad-hoc and present a rather stagnant expenditure composition, and do not meet critical TFC guidelines on salaries, interest expenditure, and the fiscal deficit.<sup>32</sup>

### E. Improving the Budget Formulation Process

The state has a process in place for budget formulation. Given the objectives of the FRBM, the challenge is to modify the budget formulation process and associated



<sup>31</sup> GoHP has tabled a revised MTFP with its 2007–08 budget. This is described in Annex 1. See also Annex 5 for details on the MTFP, and a debt sustainability analysis.

<sup>32</sup> In 2011–12, interest continues to be over 20 percent of revenue receipts classifying the state as “debt stressed”; salaries exceed 35 percent of revenue expenditure net of interest payments and pensions; the fiscal deficit exceeds the target of 3 percent of GSDP by 2008–09.



documentation to better link policy goals and resource allocation, and to embed the medium-term perspective in budgeting.

The process of annual budget preparation should ideally follow the following stages:

- Assessment of overall resource availability and adoption of aggregate expenditure and revenue targets;
- Disaggregation of aggregate targets into department targets;
- Preparation and distribution of budget guidelines, including department ceilings and their distribution to spending departments ('budget call circular');
- Preparation of submissions by spending departments;
- Review of submissions by the Finance Department;
- Preparation of draft estimates;
- Legislative approval of draft estimates.

HP's budget formulation process requires strengthening that would enable the Cabinet to review and prioritize competing policy, programme, and project proposals, and thereby allocate resources to departments based on availability. Budgeting in HP, as in other Indian states, follows the latter part of the process, beginning with the budget call circular and submissions by line departments. The earlier stages—determination of aggregate resource availability and department expenditure ceilings—are crucial for a credible budget process. Aggregate targets must be agreed upon at the political level before budget elaboration can proceed. In practice, most budgets are incremental, taking the previous year's allocation as base, adding a small percentage for inflation and some real growth. Incremental budgeting reflects a mismatch between policies and resources, and excessive focus on funding at the expense of policy in budget deliberations.

Each department must develop budget proposals within **prior indicated ceilings**. The key issues in arriving at the departmental ceilings are: (i) sequencing the preparation of a *medium term fiscal programme*, which defines desired fiscal targets (the fiscal deficit, revenue deficit, and guarantee limits), and establishes broad multi-year parameters for the budget; (ii) preparing *estimates of expenditure* to implement ongoing policy, programme, and project commitments; (iii) deriving the *estimate of the fiscal space* over the medium term to accommodate new commitments consistent with the fiscal plan parameters; (iv) ensuring that decisions on new policy proposals are considered within the constraints defined by resource availability; and (v) preparing a full annual budget that is *consistent* with the medium term fiscal programme. The expectation is that each department would take the resource ceiling as given and prioritize spending among its activities to achieve its objectives.

As a first step, the Finance Department can prepare broad **expenditure estimates** based on current policy, and examine its sensitivity to changes in economic estimates. The objective is to gauge affordability over several years, and provide for early warning indicators if some programmes are likely to grow beyond affordable limits and explore policy options. The initial estimates would be a baseline, assuming continuation of current spending levels or laws—assuming no changes in policy. Two sets of estimates can be prepared—one that assumes current levels of discretionary spending and current laws of mandatory spending, and another that assumes that current normative and other laws with implicit commitments are fully funded. This will help identify the 'policy gap' or difference between current levels of public spending and requirements to fill policy commitments (such as MDGs).

The revenue and expenditure estimates could form the basis for a **fiscal policy paper** for presentation to the Cabinet, and inform senior officials of basic economic issues and linkages between government policies and outcomes. The objective is to obtain a Cabinet decision on overall government revenue, expenditure, deficit policy, and framework. At this stage of budget formulation, the Cabinet could commit to a medium term fiscal



programme that defines the hard annual and medium term budget constraints. The medium term fiscal programme would have to be submitted for Cabinet discussion, and approval obtained by September or October in order to establish the broad parameters for revenue, deficit, and borrowing over the next three years.

The budget formulation process would also need to enable the Cabinet to **review and prioritize** competing policy, programme, and project proposals, based on resource availability. Some sectoral allocations may have been developed in the course of the fiscal policy discussions where key sectoral trends may have been identified as threats to policy or fiscal stability. The remainder of funds needs to be allocated reflecting general policy directions of GoHP. Within sectors, it is important to distinguish between discretionary and mandatory spending. The best estimate of mandatory spending for these programmes could receive full allocation, while discretionary programmes would receive residual amounts. This stage will generate a 'development debate', clarifying policy issues and resolving programme related tensions. Once approved by Cabinet, these indicative ceilings for each sector/department would be transmitted to departments usually as part of the annual budget call circular that initiates the budget process.

Having received sector or department indicative ceilings, each line department must develop its **budget proposal**. At this stage, departments are expected to think strategically about their programmes, evaluate their existing programmes, and analyze what inputs or policy will best help them attain an objective by maximizing the effectiveness and efficiency of spending. These reviews and plans should be undertaken either as part of the annual budget cycle or prior to it, and then fed into the resource allocation decisions in the budget process. The budget requests to the Finance Department must separate existing programs from new requests, and apart from numbers, contain text explaining policy, changes in policy

from the past, reallocation decisions, new objectives, and output and outcome targets associated with the resource levels and allocations. An important issue here is for the line departments to develop capacity for policy and programme evaluation skills through training.

A **formal process** to critically review ongoing programmes as part of the budget process will also help ensure their efficiency. Some state governments have undertaken a one-time zero-based budget review to rationalize government programs (Box 2.2 above). Establishing an Expenditure Review Committee (as in Australia) to critique ongoing programs and rationalize would be a useful supplement to the existing annual budget process.

After receiving the requests, these must be **reconciled** with resource ceilings and competing demands, and final policy and funding decisions should be reached. The Finance Department's role is to provide critical analysis of the line agency's request and conducting fair hearings of their request. Line agencies must be questioned in detail about their requests, assumptions, and underlying data. The Finance Department must report new programmes separately from ongoing programmes in the interest of fiscal transparency. The assessment should include reviews of capital spending, progress in capital projects, and whether external and internal audit findings have been addressed by each line department. This must feed into the Finance Department's recommendations for funding.

## F. Strengthening Public Financial Management and Procurement Systems<sup>33</sup>

The state's public financial management and procurement systems present both strengths and weaknesses. Going

<sup>33</sup> See Annex 7.



beyond budget formulation, the process of approval of the budget by the state legislature is well established, and recent budgets have been approved in a very timely manner. Transaction level controls over the budgeted expenditure are exercised. Interim and Annual Accounts are reconciled and prepared on a regular and timely basis. External audit is comprehensive, regular, and reports are made available on a timely basis. The process of legislative oversight over matters reported in the audits is discussed in the fora of the Public Accounts Committee (PAC), and required directions are issued for corrective action. At the same time, the state's public financial management system is in the need of modernization in the areas of budget management and execution, accounting and financial reporting, internal controls and audits, and legislative oversight.

The **Budget documentation** process could be improved. The *presentation* of the document itself is rather detailed, and not easily understood. Though there are attempts to summarize/explain the Budget details through an Explanatory Memorandum, the state could work on presentation aspects to enable the public to understand and analyze the complex budget. More importantly, budget documentation should be *rationalized as outlined in the FRBM* to achieve the fundamental shift in approach to budgeting and the quest for greater transparency. The Act proposes to introduce potentially valuable and relevant information to clarify the forward-looking medium term fiscal program of the state, an evaluation of past performance, and an assessment of the conformity of ongoing and proposed policies with the medium term programme. For greater transparency, it would be appropriate for GoHP to also reassess how the remainder of the documentation on the budget could be rationalized and made more relevant for informing legislators and civil society about public policy and resource management.

In addition, the state could begin a process of **mid-term reviews and reporting** as required under the FRBM. The Finance Department must strengthen within-year monitoring of the budget, prepare occasional reports

for the Cabinet, and propose corrective actions. As mandated in the FRBM, a report on mid term turnout, risks to achieving budget targets, and corrective measures should be tabled in the Legislature, and be publicized through the state website to inform public opinion and build support.

Additionally, in the area of **public financial management**, there is scope for: (i) improving *budget marksmanship/accuracy* in cases of certain large departments, where excesses have been consistent and significant; (ii) including *adequate information* relating to guarantees, and status of the investment in PSEs, others in Annual Financial Statements; (iii) reinforcing *responsibility and accountability* of the Head of the Department (HoD) to ensure more effective utilization of resources and strengthen internal controls; (iv) enhancing *effectiveness of officers* responsible for 'inspection' in the spending departments, where formal Internal Audit does not exist; (v) more *effective response* to audit by co-coordinating timely response from line departments and addressing systemic issues consistently appearing in audit reports; and (vi) *reducing delays* in legislative oversight.

**Public procurement** in HP is governed by Procedure & Rules for the Purchase of Stores, which is an appendix to GoHP's Financial Rules. These are maintained by Controller of Stores under Ministry of Industries, and relate to procurement of goods. While the Store Purchase Organization is the nodal agency for negotiation of rate contracts, there is an increasing effort to decentralize department specific purchase to the respective departments. Procurement takes place amidst a large number of controllers and overseers. Improving oversight of procurement involves rationalizing control as well as increasing the ability of the government and the private sector to monitor performance. The existing rules provide a preference for domestic suppliers with an aim to promote the local industries. It needs to be reviewed whether such preferences actually result in the desired effect. Simplification of laws and regulations is often best accomplished through the adoption of a modern procurement law that applies to all kinds of



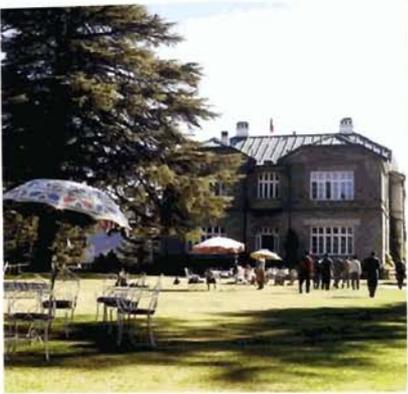
procurement undertaken using public funds (goods, works and services).

Some additional steps could be considered to improve public financial management and procurement.

- In order to improve **financial reporting**, GoHP could include information relating to guarantees, and status of the investment in PSEs in the Annual Financial Statement. It could also begin presenting information on revenue due but not collected, payables, and outstanding commitments.
- In the area of **internal controls**, (i) responsibility and accountability of the HoDs need to be reinforced in order to ensure more effective utilization of resources and in general strengthen internal controls; (ii) the Himachal Pradesh Financial Rules, 1971, which are outdated, difficult to interpret and require reference to numerous circulars, need to be revised; (iii) responsibility to discharge both the Treasury and Subordinate Accounts Service functions could be combined and skills development needs of staff could be assessed; and (iv) an Internal Audit function might be created by setting up a small, skilled team to review areas of perceived risk.
- **Treasury computerization** needs to be rolled out to cover the entire state; this will greatly improve public financial management in general and internal controls in particular.
- In **procurement**, the state should adopt a modern procurement law that applies to all kinds of procurement undertaken using public funds (goods, works and services). A public procurement disclosure policy can improve the flow of information on procurement, and allow for public participation in monitoring and oversight. A review of the Financial Management and Procurement Policies of the PSEs could be undertaken with a view to modernizing practices; the government may start with the two largest PSEs.

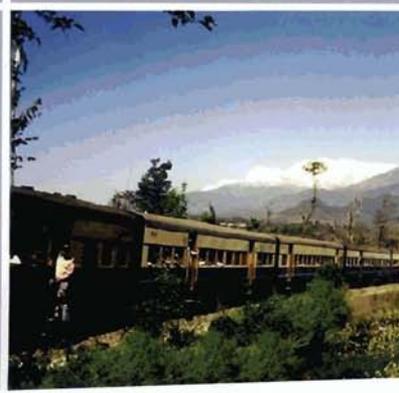
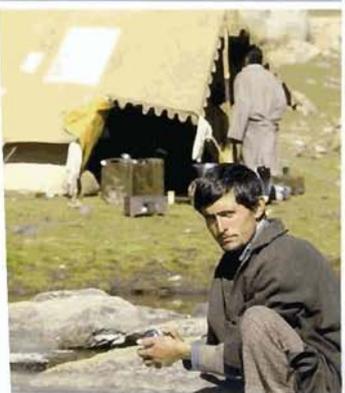
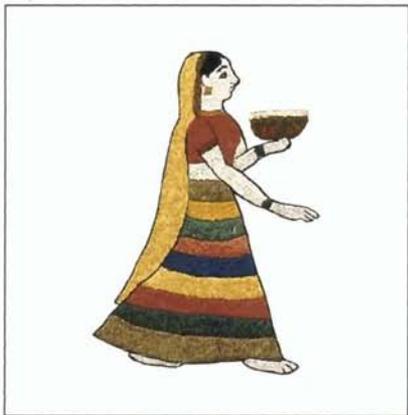
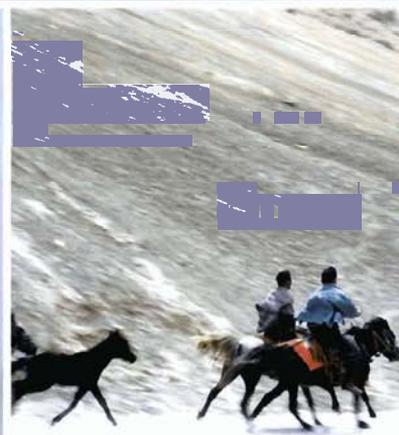






03

# Improving the Investment Climate for Private Sector





## Improving the Investment Climate for Private Sector

Policy makers in HP recognize that a vibrant private sector is central to promoting growth and expanding employment opportunities. Effective partnerships with the private sector could enhance the efficiency of the state's economic performance, reduce the burden on the public sector, and free public resources for critical investments. However, HP continues to be heavily dependent on the government for its economic development. This chapter looks at the key constraints that affect private sector participation in the state.

### A. Challenges in Industrialization

HP has achieved significant progress in industrialization, more so since fiscal incentives were made available to industry. Since the announcement of the Special Incentive Package by GoI in 2003, the state has received investment proposals of close to Rs. 200

billion (including new units and expansions of existing units) with proposed employment of more than 280,000 persons (Box 3.1). Actual realized industrial investment has increased by about 50 percent since 2003. The key sectors are cement, textiles, food processing, pharmaceuticals, engineering, electricals, and electronics.

The recent momentum in investment proposals presents three key challenges for the state, which are manifestations of weaknesses in the business climate. First, even though actual investments have gone up more than 50 percent since the announcement of the incentives in 2003, the *investment realized* in the state is still only a low percentage of investments approved (Figure 3.1). Of the 19,279 small, medium, and large units approved since January 2003, only 1,303 had been actually established till July, 2006.<sup>34</sup> Second, since the announcement of the package, most of the proposed

<sup>34</sup> However, even with a low rate of realization, there has been significant expansion. At present, the state has industrial investment of about Rs. 46 billion—of which Rs. 15 billion has come in after the announced package, of the total approval of about Rs. 192 billion.



### Box 3.1: Special Incentives for HP's Industrial Development

Himachal Pradesh has been the recipient of a grant of a special package of incentives by GoI (2003), as well as an investor friendly state Industrial Policy (2004). These have attracted significant investment proposals in the state, which has contributed to growth in the secondary and tertiary sectors.

#### Central Incentive Package

In March 2003, GoI announced a special incentive package for industries in “special category” states. The industries eligible for such incentives were to be ‘environment friendly with a potential for local employment generation and use of local resources.’ The main fiscal incentives included the following.

- (i) New industrial units and existing industrial units on their substantial expansion, set up in Growth Centres or Industrial Infrastructure Development Centres (IIDCs) are entitled to:
  - 100 percent outright excise duty exemption for a period of 10 years from the date of commencement of commercial production.
  - 100 percent income tax exemption for an initial period of five years, and thereafter 30 percent for companies and 25 percent for other than companies for a further period of five years from the date of commencement of commercial production.
  - Capital investment subsidy at the rate of 15 percent of investment in plant and machinery, subject to a ceiling of Rs. 3 million.
- (ii) Thrust sector industries identified in the package—such as horticulture, food processing, pharma products—are entitled to similar concessions as mentioned above without any area restrictions.

In the original proposal, the excise and income tax concessions were valid for industries which commence production up to March 2013. On opposition from neighboring states, however, the validity period for excise concessions was initially reduced to March 2007, but has now been extended up to March 2010. As per latest reports, the tax incentives may now be limited only to fresh investment. Since the notification of special package, several major private companies have come into HP. These include cement majors like ACC and Gujarat Ambuja, pharmaceutical firms Dabur, Ranbaxy, as well as electronics and textile companies.

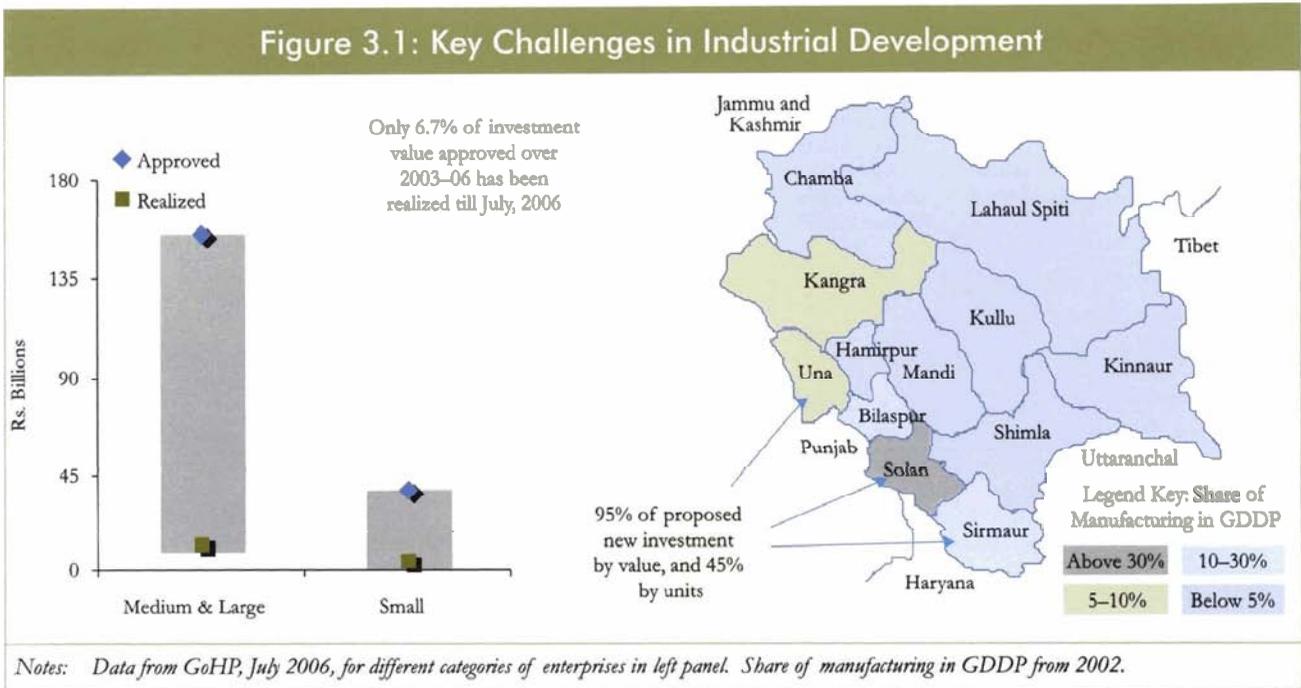
#### State Incentives

With a view to ensure balanced industrialization in the state and to generate employment opportunities for local persons, GoHP has enacted a new Industrial Policy (2004) where it provides graded incentives to the industrialists so that industries being set up in the interiors of HP get higher incentives. The fiscal incentives being offered include subsidies, concessional rate of electricity duty, and deferment of the Value Added Tax. The state has also introduced a single window clearance and monitoring authority to ensure speedy approval from various departments and agencies. A Special Economic Zone is also being set up in the Kangra, Una, and other districts of the State, with an estimated cost of over Rs. 50 billion. The units located in this economic zone can avail certain specific concessions and facilities like exemption from the payment of central excise duty, levies, specified taxes, relaxation in labor laws. The new units are however eligible for the state incentives only if they employ at least 70 percent of its total manpower, whether on regular/contractual/sub contractual/daily basis or any other mode from amongst the bonafide Himachalis.

new investments are clustered in the ‘peripheral’ districts bordering Punjab and Haryana, which were already more industrialized than the interior districts (Figure 3.1). While the state should try and ensure a more

balanced pattern of development, it could also facilitate the migration of workers from the interior districts to where the jobs are being created. Third, it is important to ensure that the new investments that have come into





the state remain after the special incentives are phased out in 2010.

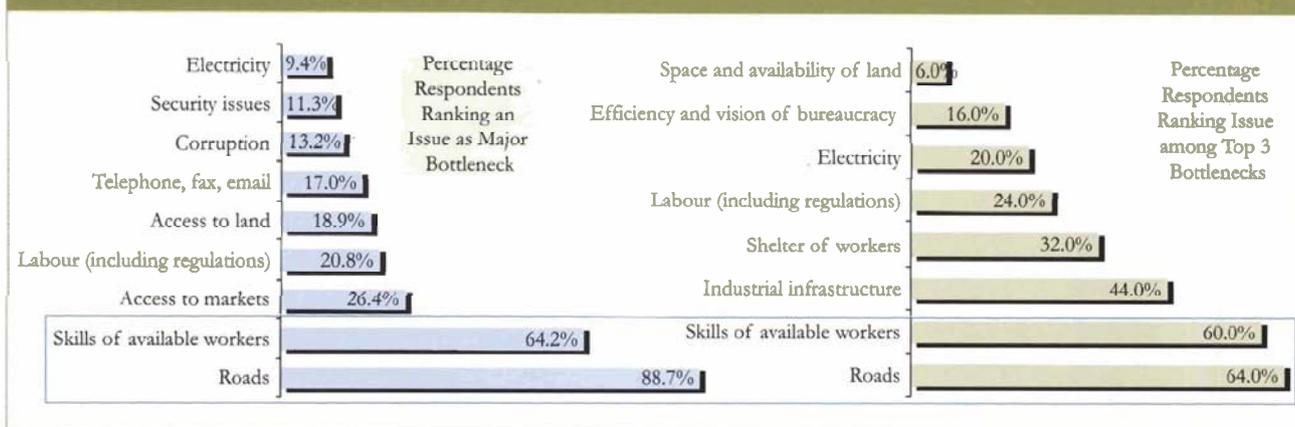
HP actually enjoys several general advantages that could attract the private sector. First, the state has access to *cheap power* because of its hydro-power potential. Consequently, industrial power tariffs in HP are significantly lower than those in its neighboring states of Punjab and Haryana.<sup>35</sup> Second, HP ranks better than its neighboring states in the *law and order* situation.<sup>36</sup> Third, HP's *bureaucracy* is considered far less corrupt and more approachable than its comparator states.<sup>37</sup> Fourth, HP's natural terrain and agro-climatic conditions give it a distinct *comparative advantage* in attracting certain industries like tourism, horticulture, floriculture, and hydro-power. Finally, GoI's *Special Incentive Package* provides special concessions for specific industries, as discussed above.

However, HP's advantages are being offset by key bottlenecks that have stifled private sector participation. A quick primary survey of the private sector's view on the general investment climate suggests that the major constraints are poor road infrastructure and skills of laborers available for work (Figure 3.2). The other issues highlighted by investors include access to reliable electricity (frequent power outages), labor regulations (especially the requirement of 70 percent local employment), and industrial infrastructure, including availability of low-income housing for labor in the developing industrial zones. The issue of urban development assumes importance in this regard, as most private industries set up in relatively urbanized areas, and require basic infrastructural support. Industrial regulations appear less of a problem in the state, as per the survey.

<sup>35</sup> Industrial tariffs in HP are around Rs 2.1/kWh v/s Rs 3.4-4.1/kWh in Punjab and Haryana.  
<sup>36</sup> In the recent India Today ranking of states, HP ranked 6 on the Law and Order index compared with 11 and 13 for Haryana and Punjab respectively. See 'State of the States Survey', India Today, August 2006. The factors considered in the law and order ranking are: 1) policemen per lakh population, 2) ratio of pending cases to total court cases, and 3) incidence of murder, kidnapping and rape or molestation in total crime.  
<sup>37</sup> In Transparency International's ranking of Indian states on corruption, HP is the second least corrupt state in India after Kerala.



Figure 3.2: Major Constraints for the Private Sector



Notes: Data for major bottlenecks based on a quick survey of 54 firms in HP conducted in October–November 2006 to identify the constraints to the growth of HP's firms. The survey covered firms across auto ancillaries, chemicals, garments, light engineering, pharmaceuticals, and textiles.

## B. Improving the Business Environment

It appears from the quick survey that private firms in HP regard poor road connectivity and quality in the hilly terrain and lack of skills of available workers as the two key constraints. Since most industries and services develop in urban areas, productive and sustainable urban development would be a key to the state's development agenda. If the government could address the challenges in these key areas, it would help promote private participation in the economy. It would also have additional desirable effects in terms of better living standards, improved connectivity for remote areas, and better employment opportunities for the educated population.

### Upgrading Road Quality and Connectivity

The state does not do well in terms of connectivity. As compared to the national average of 76.8 kms. of roads per 100 sq. km., the corresponding figure for HP is only 41.6 kms—largely on account of remoteness and terrain. More importantly, rural connectivity is low, even

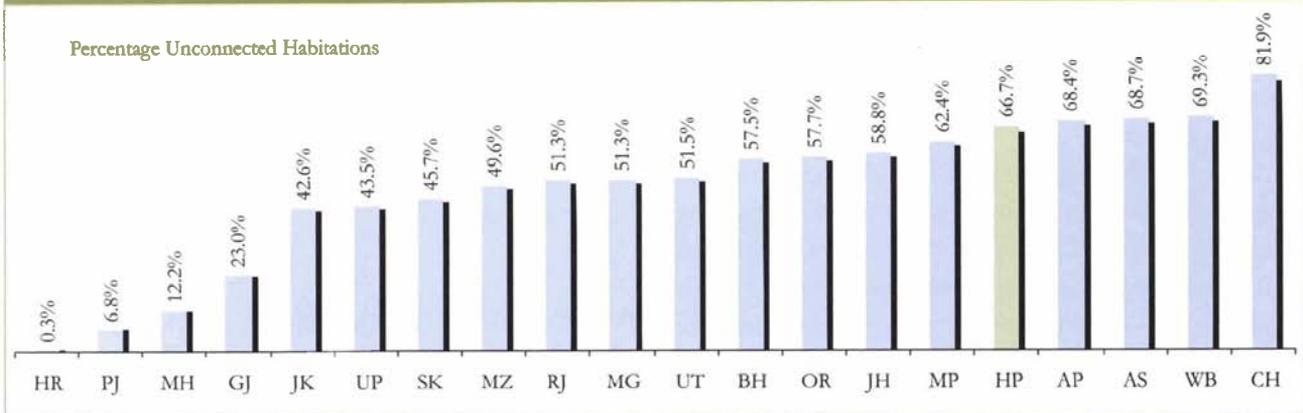
compared to other hill states like Uttaranchal and Sikkim (Figure 3.3). Poor quality of the state's main arterial roads is recognized by the state to be a particularly important issue. Only about half the roads are metalled and tarred, and suitable for all weather conditions.

### Key Policy Challenges

- The sector suffers from high unit costs but *inadequate funding*. Due to the difficult terrain and remote locations, the unit cost for road development and maintenance are 50–100 percent higher than equivalent works in neighboring states with rolling or plain terrain such as Punjab. At the same time, the sector is inadequately funded. It is estimated that, given the unit cost for upgradation of an existing single lane road to double lane of Rs. 20 million/km., just to upgrade the core network would cost more than Rs. 80 billion.
- The Public Works Department (PWD) has to contend with *high fixed costs*, with a salary bill that crowds out critical non-wage O&M. The PWD is saddled with a large gang workforce, and the overall productivity of this workforce is unclear. About two-thirds of the budget provided for maintenance is used up in paying the salary of these staff, leaving only a small sum for periodic



Figure 3.3: Poor Rural Connectivity in HP



Notes: Data from Pradhan Mantri Gram Sadak Yojana (PMGSY) for 2004–05.

maintenance. This has resulted in a large backlog of periodic maintenance works and poor condition of the network.

- The *service levels* on existing networks are low. Due to the focus on enhancing rural connectivity and inadequate maintenance, the service levels are currently poor with respect to volume/capacity, surface riding quality, lack of cross drainage/slope protection works, weak pavement structure, poor horizontal and vertical geometry, poor junction layout, periodic closure of roads due to landslides, inadequate snow clearance equipment, limited road signage, and absence of traffic management in built up areas.
- The sector is affected by *outdated management and implementation practices*. Almost all road works in the State are undertaken through the HP PWD. The organizational structure in HPPWD differs from modern road agencies in several important ways including: (i) a geographic division of functions, and absence of specialization within the PWD; (ii) use of force account to undertake a large amount of activity; (iii) virtual absence of research or development in technology and management

practices; (iv) low level of Information Technology (IT) use for planning, monitoring and reporting; (v) continued use of outdated procurement, quality control and financial management practices; (vi) absence of departmental vision, outcome performance measurement system, or link between policy and customer expectations; and (vii) lack of an effective human resource development programme.

### Strategic Options

Although there is no formal Road Sector Policy in the state yet, the 2006–07 Budget Speech stated that rural connectivity and better roads are of the highest priority in accelerating economic growth. The state has a two-pronged vision for the sector—extension of the rural network along with simultaneous improvement to the core network of 2,160 km. of state highways and 2,240 km. of major district roads.<sup>38</sup>

In order to realize the vision, the state needs to:

- (i) clarify the **policy framework**, by formulating a

<sup>38</sup> A World Bank investment lending project is under preparation to support improvements and management of the core network in HP, and is expected to go to the Board in FY 2006–07.



Road Development Policy, and associated monitoring and evaluation, including adequate integration of low cost rural access in all areas including forests, and establishing a high level standing committee to promote sustainable policies for road development and maintenance, and interagency coordination; (ii) improve **maintenance funding**, through measures to revise norms for maintenance, provide increasing allocations as per norms on a timely basis, encourage local governments to help fund maintenance, assess feasibility and implications of transferring non core roads to local bodies, create a road maintenance fund through existing and new resources along with an empowered committee to manage it, and remove the backlog in deferred maintenance in a phased, time-bound manner;<sup>39</sup> (iii) revisit the current **institutional structure**, by reviewing the organization and training needs of PWD staff, and establishing and applying revised staffing patterns, job descriptions, and responsibilities along with a suitable training programme, as required; (iv) upgrade **sectoral planning** by establishing and applying simple procedures for data collection on road inventory, surface condition, and traffic, so as to be able to update and generate management reports on completing routine works and prioritizing periodic maintenance works at district level and state level; (v) undertake a thorough assessment of costs and benefits of the **gang labour system**, which is ongoing, and look at reform options to enhance productivity of gang laborers through improved management practices, to devolve of part of gang labor strength to local governments to look after non-core roads, and to undertake pilot projects to convert gang labor to small contractors; and (vi) improve **construction quality** by establishing and strengthening quality control system in order to counter low quality at time of original design, introducing second and third party audit within the Department for all construction and maintenance works, promoting

mechanization, new materials and specifications, and improved work methods and techniques, and setting out clear norms and guidelines for non-PWD roads being constructed by districts and block authorities. In addition, the state seeks increased reliance on GoI funds both for national highways, and from the Pradhan Mantri Gram Sadak Yojana (PMGSY) to tackle the issue of rural connectivity.

### Addressing the Skills Mismatch

A second issue is the skills of available workers, which is cited as a constraint by private sector representatives.<sup>40</sup> At first glance, this is surprising, since the labor force in HP is quite well educated. Just under half of the labor force had completed high school and above, among the highest in the country (Figure 3.4). While graduates and post-graduates are over 12 percent of the working labor force, technical diploma and professional degree holders constituted over 3 percent in 2004–05 (Figure 3.4). However, the state is simultaneously facing the problem of educated unemployment—even for people with technical degrees (Figure 3.4). Interestingly, coincident with the special incentives from the government, the number of technical degree holders registered at employment exchanges has risen from 34,064 in 2002 to 40,013 in 2006—an increase of over 17 percent! Moreover, the problem of educated unemployment also seems to be rising, with more educated people registering in employment exchanges even in the face of rapidly growing secondary and tertiary sectors, indicating either unemployment or the desire to switch to some other job (Figure 3.4).

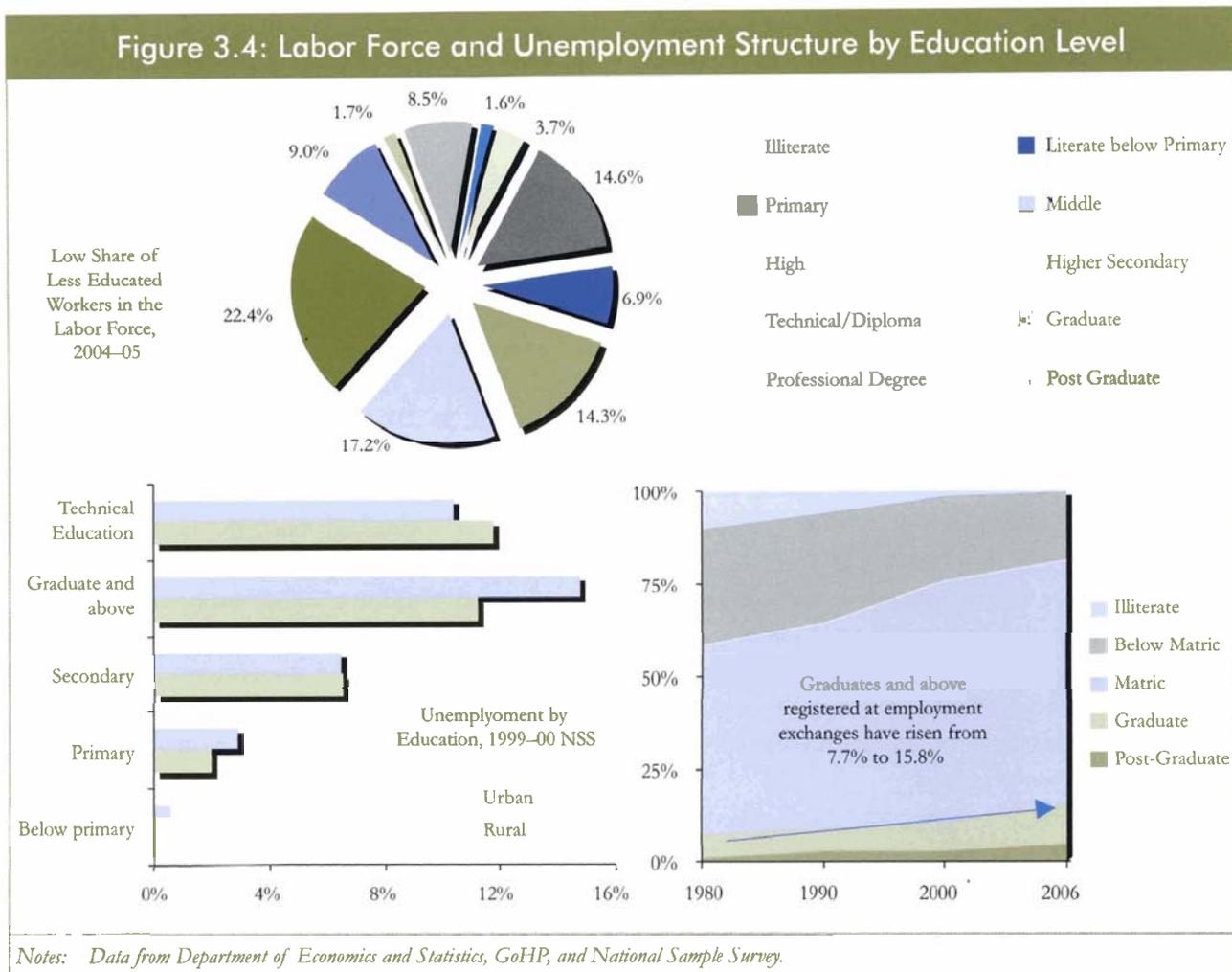
This suggests that the problem is not so much of supply, as one of mismatch between the skills being imparted through the formal education system and those required

<sup>39</sup> The state has already endorsed a Road Maintenance Action Plan and GoHP needs to focus on steadfast implementation of the Plan.

<sup>40</sup> It should however be kept in mind that this constraint would arguably be less severe if the industry did not have to meet the requirement of employing 70 percent of the workforce from the local Himachal populace.



Figure 3.4: Labor Force and Unemployment Structure by Education Level



by the upcoming industries. There is thus a case for GoHP to focus on revamping the education system to better equip Himachalis to take up new jobs that are becoming available.

What sort of skills does industry require? At the workmen level, discussions with industry representatives suggest, and international evidence also backs up, that they are basically looking for workers with the skills taught in general secondary education, along with

technical skills.<sup>41</sup> Support for the proposition that industry values secondary education highly also comes from data which shows that the mean wages of workers with higher secondary education are 44 percent over those earned by high school graduates. Technical education adds additional value and raises mean wages further by an additional 8 percent.<sup>42</sup> Beyond this level, the main source of employment for workers with tertiary education is in the service sector, especially in the public sector.

<sup>41</sup> This is based on field visits, and discussions with representatives from 53 industries in HP.

<sup>42</sup> Ministry of Finance, Government of India 2005; Bank Staff Estimates



Accordingly, provision of technical training has the potential of meeting industry demands and raising workers' employability and incomes. The state currently provides vocational and technical education in Grades XI–XII in the school system, and through 5 engineering colleges, 6 polytechnics, 51 public and private Industrial Training Institutes (ITI), 24 private Industrial Training Centres, and 112 Vocational Training Centres. However, this stream has not found favor with students: the share of students entering technical education is small in the state, with most students preferring to join the general academic stream. Only 12 percent of students entering higher education chose technical education in 2002—and this share declined to under 8 percent in 2003–04, lower than the national average of almost 11 percent. It is important to keep in mind, however, that if the state develops its natural resources and comparative advantages, for example, in tourism and hydropower, it is likely that shortages of specific, related skills will emerge in the future. Without a proactive strategy to develop an appropriately skilled labor force, economic growth of the state can also be compromised.

The state presently lacks hard data to estimate where the skill mismatches are or forecast where they may arise in the future. This is an area where further analysis is required. There is, however, anecdotal evidence that, other than the skills gap, there are other “mismatches” which need to be factored in: (i) many of the new jobs created in the developing industrial belt bordering Punjab and Haryana require relatively low level skills, and the educated youth of HP are unwilling to take up these jobs while employers can also fill these positions more cheaply by migrant labor from outside the state; and (ii) poor infrastructure facilities and living conditions in the industrial belts may be deterring native Himachalis from migrating to these areas in search of employment.

The first is the mismatch between industry requirements and workers' expectations. As noted earlier, industry finds it easier to hire and train secondary pass-outs, and the demand for more qualified non-technical graduate and post-graduates is limited. Discussions indicate that educated youth of HP are unwilling to take up these jobs. This is consistent with the experience elsewhere in India, that the “organized” sector—which offers better pay and job security—is the sector of choice for better educated workers.<sup>43</sup> Within the organized sector, the public sector is the dominant provider of employment. In 2001, 0.31 million workers, or more than 10 percent of the workforce were employed in the organized sector, but only about 48,000 of these were in the private sector.<sup>44</sup> In part, the high dependence on the public sector itself may be a response of a well-educated workforce whose expectation in terms of employment are increasing, but where the current industrialization pattern in the economy has not been able to generate enough suitable private sector jobs to meet their aspirations. For many, migration out of the state is a better option. As per the 2001 census, about 0.4 million people—or about 6 percent of the state's population—reported themselves as having moved out of the state, of which more than a quarter had moved due to employment-related reasons.<sup>45</sup> Employers too find that they can also fill positions more cheaply through migrant labor from outside the state.

The second mismatch is between the more populated districts of the state (Kangra, Mandi, and Shimla), and those where new industrial units are coming up (Una, Bilaspur, Solan, and Sirmaur). Taking advantage of the employment opportunities being generated here may require some Himachalis to migrate to these districts. However the poor infrastructure facilities

<sup>43</sup> Organized sector refers to employment either in the government, or in establishments employing more than 10 persons.

<sup>44</sup> Nationally, 7 percent of the workforce is in organized sector employment.

<sup>45</sup> Over half the migrant male Himachalis had moved out of the state in search of employment. For women, however, the most important reason—accounting for over half of female migration over the 1990s—was marriage-related.



and living conditions in the industrial belts may be deterring native Himachalis from migrating to these areas.<sup>46</sup> Limited evidence for this comes from census data which shows that for inter-district migration of Himachalis within the state, against an average in-migration rate of 5.4 percent for all HP districts, the combined in-migration rate for the more industrialized border districts was less than 5.1 percent.<sup>47</sup> In fact, industry representatives claim that they are unable to fill 70 percent of their jobs with local youth as per state policy because they do not find enough applicants for these jobs.

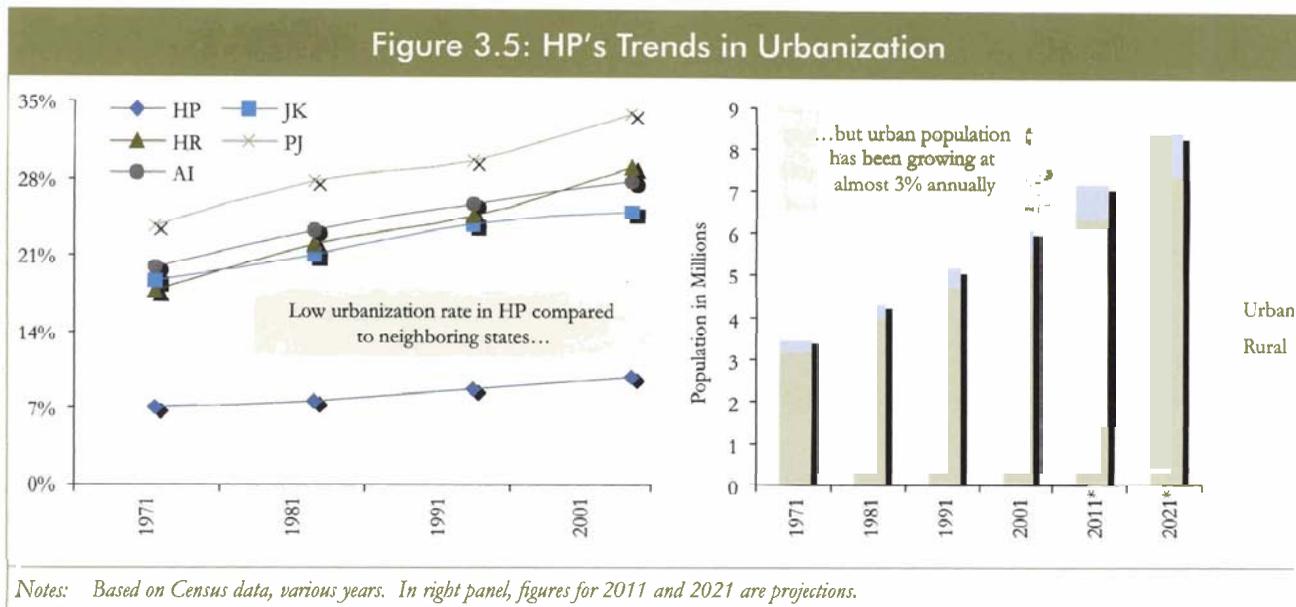
In order to address the challenges in this area, the following measures could be considered by GoHP.

- The state proposes to undertake a **study on skills mismatches and shortages** in HP. This will be an important step, since the extent of skill gaps and mismatches in the state is unclear at present. This constrains evidence-based policy reforms. The study would include a skills-mapping exercise, to identify particular sectors which would emerge in the near future, so that skill requirements could be projected. Based on this, the state needs to come up with a skills development strategy to bridge current and future skills shortages and skills mismatches—worked out in consultation with industry, workers, and educators.
  - Going forward, a **Labor Market Information System (LMIS)** needs to be established to provide both the demand and supply side of the labor market with timely information on skills that are in demand or available for hire. An LMIS will improve the efficiency of individuals' decision to invest in their human capital by enabling them to make education and training choices that have a more certain and larger pay-off in the labor market. It will also aid the government in
- not spreading thinly scarce public resources but undertaking targeted interventions to correct for market failure or equity in the labor market.
  - There could be greater **public private cooperation** in the planning and operations of technical/vocational education in the state. The government has implemented the Industry Management Committee (IMC) concept at the Industrial Training Institutes with private participation, but these Committees are severely restrained in the extent of delegation of powers on key issues (recruitment, pay scales, and curriculum). GoHP is cognizant of this and has engaged in dialogue with the private sector. However speedier movement on key action items, such as updated online employment exchange, empowerment of IMCs, mapping studies for required skills, etc. is needed. Since this issue requires coordination amongst various government departments, a single champion must be designated and an inter-departmental coordination mechanism should be instituted with regular monitoring of progress.
  - The **single window clearance system** in HP has been in effect for more than five years. The state proposes to initiate a study to evaluate the effectiveness of business facilitation measures at the state and district level, including lessons learnt from single window system in HP and other states. Findings from the study would inform adoption or refinements in business facilitation measures.
  - The state could **promote migration** to districts where the new jobs are coming up. This would involve improving infrastructure and living conditions in the industrial belts in the border areas, where discussions with industry representative and field visits suggest an unfinished agenda. This would require private participation, as well as fiscal resources.

<sup>46</sup> A field visit to the Baddi and Bilaspur industrial areas highlighted the lack of suitable housing and sanitation and sewage facilities as major problems faced by workers in the area.

<sup>47</sup> The border districts considered here are Solan, Sirmour, Bilaspur, Una, and Kangra, which are more industrially developed as per Figure 3.1.





## Improving Urban Infrastructure

In order to sustain and accelerate the economic growth, it is vital for the state to develop a competitive and productive environment for private sector led economic development—and urban development is key, since secondary and tertiary sector industries typically flourish in an urban environment. Urbanization for the state is likely to increase due to continued focus on tertiary and secondary sectors. In HP, urban development also has implications for the environment and for living standards of the population.

Even though HP's urbanization rates are considerably lower than national averages and in neighboring states, urban population is growing faster than rural population, and urbanization rates are projected to rise (Figure 3.5). Starting with 36 towns/urban agglomerations in 1971, HP now has 57 towns/urban agglomerations which are collectively home to a population of almost 0.6 million. Shimla is the only Class I town in the state, and Shimla district consequently has an urbanization rate of almost a quarter. The industrial border districts of Solan and Sirmour also have high urbanization rates.

Given the development trends observed, the state is facing the following urbanization challenges: (i) the lack of proper industrial infrastructure and housing in the fast growing towns in the lower part of the state and close to the border with Punjab and Haryana, and the consequent issues for industries that are establishing and expanding there; (ii) the likely expansion of small towns in the hilly areas due to the growth of population, tourism, and other services, and the need to equip them for establishment or expansion of small scale industries and services in an environmentally sustainable manner; (iii) the somewhat chaotic development of Shimla, which is the only Class I town in the state, and the consequent problems, such as illegal construction, encroachment of public space, traffic congestion, air and water pollution; (iv) the need for strengthened capacity for city planning and management; (v) the inequity and potential social instability due to lack of housing and social services for those cross-state migrants and immigrants; and (vi) the likely threat to the natural and cultural heritages, and the need to protect and enhance them.

In order to promote infrastructure in urban areas, GoHP has taken several measures of note. A Baddi



Barotiwala Nalagarh Development Authority (BBNDA) has been set up in the industrial belt along the border, to oversee infrastructure development. The BBNDA is under the Department of General Administration, and GoHP is seeking to promote interdepartmental coordination with the Departments of Industries, and other relevant agencies to avoid duplication in planning and implementation of industrial area development of BBN area. The state is planning the enactment of Industrial Area Development (IADA) Act to facilitate planned industrial infrastructure development through the creation of industrial area authorities in priority locations—such as Kala Amb, Paonts, Gagret, and Kangra in the near future. The BBNDA and other IADAs, however, need strengthening through increased funding. The state could take steps to address urban issues, by focusing on three key instruments.

### Planning and Regulation

Urban plans that are non-existent, inappropriate, not enforced, or unenforceable are one of the main causes leading to economic inefficiency, and deteriorating quality of life and environment. It will be important to improve the planning process, including: (i) forecast of various long-term urban development scenarios (including spatial distribution of population and economies), and identification and evaluation of their potential economic and environmental impacts; (ii) establishment of a state-wide urban development policy framework that sets out principles and directions for planning, regulating, financing, and managing the urban development, and capacity building measures; and (iii) establishment of region-specific or city-specific development strategies and plans, which will include infrastructure investment and institutional development programmes to foster enhanced service delivery and more effective urban governance for greater urban efficiency and productivity as well as environmental protection.

### Financing Urban Development and Services

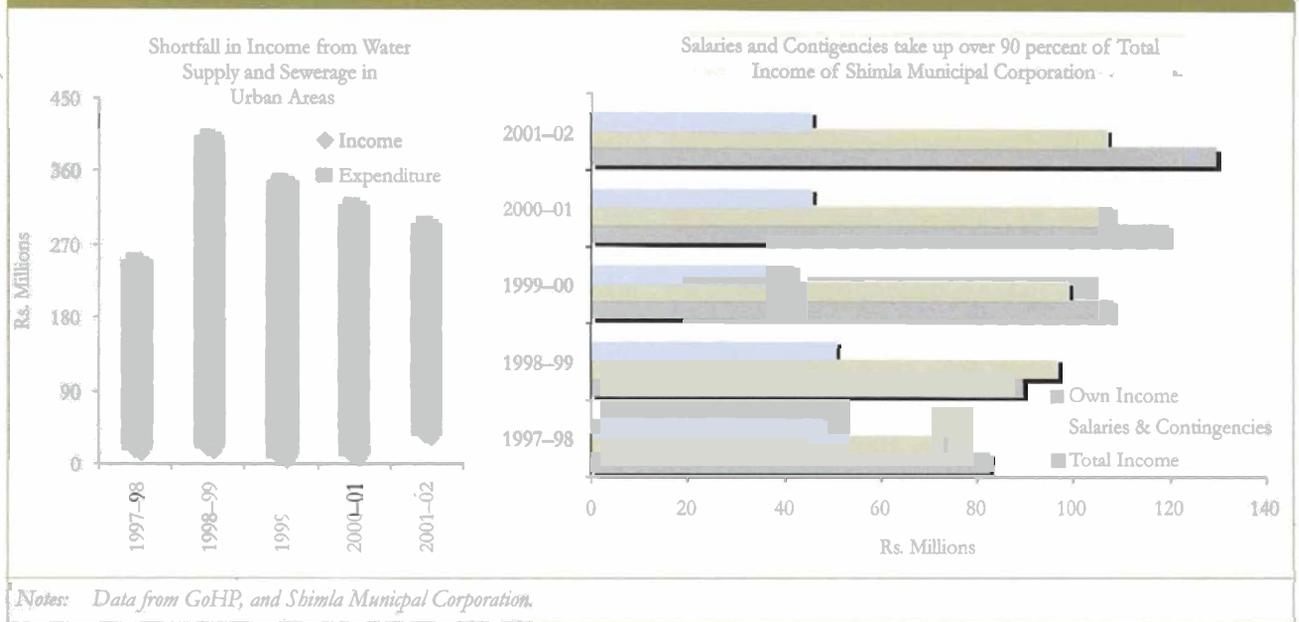
ULBs, which finance urban infrastructure through budgetary allocations, grants, and own sources, have incomes less than 40 percent of what is estimated as required to adequately finance the urban infrastructure needs of HP—indicating the need for better resource mobilization and financing from non-traditional sources.<sup>48</sup> Revenues from *taxes* collected by ULBs are low due to prevailing rates that are generally lower than in neighboring states like Punjab and Haryana. *Non-tax* revenues from user charges are not adequate even to recover the full cost of O&M, with sewerage services being provided almost free and income from water charges growing very slowly (Figure 3.6). Salaries and contingencies account for a high share of income (and expenditures). For the Shimla Municipal Corporation, salaries and contingencies account for more than double of own income (excluding grants) and about 85 percent of expenditures. While this does not necessarily imply that ULBs are overstaffed, it does reduce funds available for developmental activities.

Given the state's fiscal situation, increasing local resource mobilization should receive a strong policy attention. The first priority in this regard would be the *increase in beneficiary charges* for services, especially economic services such as water supply. Alternative organizational and financial arrangements would have to be explored, not only for the services currently provided by local governments—but also by state governments such as road transport services, tourist services, etc. Organizational options should not be limited to public corporations, but include various forms of *public private participation*. It could contribute to public financing sources rather than adding to liabilities. Other *innovative financing measures* could include accessing the capital market through municipal bonds, and involving communities in O&M.

<sup>48</sup> See Planning Commission (2005) for details.



**Figure 3.6: Financial Challenges in Urban Development**



### ***Institutional Strengthening***

Policy instruments and infrastructure investments will need to be designed and implemented by various state and city level institutions with adequate capacity. Due to the early stage of urbanization, the state's urban management institutions are particularly weak. In many

rapidly industrializing areas in the lower areas, there is no urban governance system in place. Most existing towns are hard pressed to provide minimal urban services and planning guidance, and their rapid growth is making the situation increasingly tenuous. Strengthening the capacity of local governments and service providers, and decentralization mechanisms need to be explored.





# 04

## Exploiting Emerging Opportunities for Revenue Mobilization, Growth, and Employment





## Exploiting Emerging Opportunities for Revenue Mobilization, Growth, and Employment

The state faces the challenge of exploiting the full potential in specific sectors where it has natural advantages. Development of these sectors, as identified in the Approach Paper to the Eleventh Plan and the HP Economic Survey, will allow the state to enhance growth performance, open up opportunities for productive employment, and generate revenues that can help sustain the fiscal recovery.

### A. Exploiting the Untapped Hydropower Potential

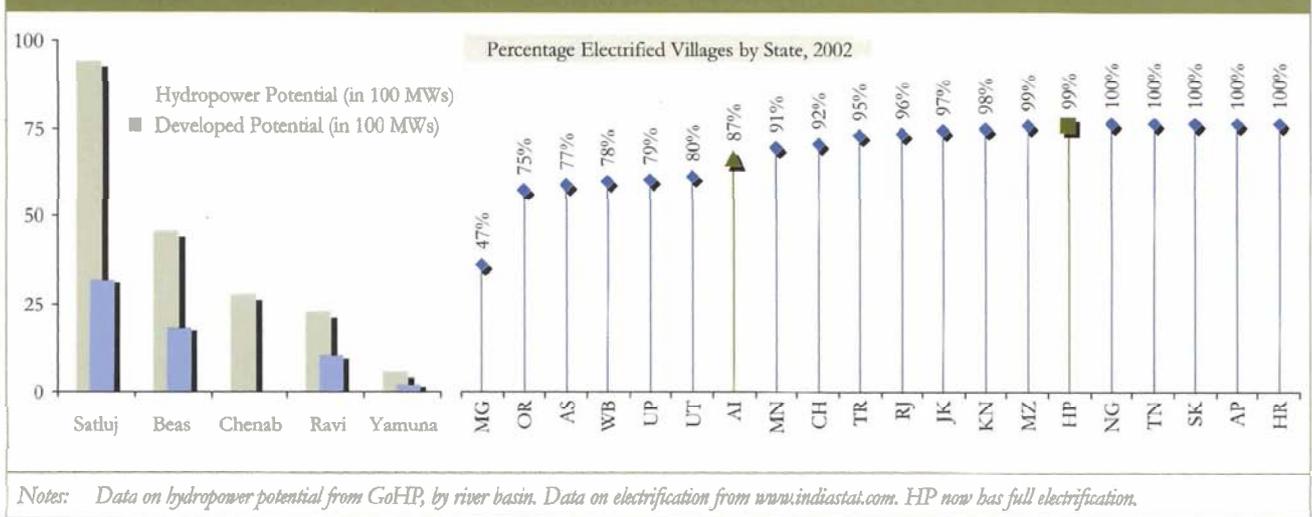
The state's hydropower potential of about 19,000 MW spread across five river basins is one of its most important strategic development assets, but almost 70 percent of this is untapped (Figure 4.1). Hydropower is particularly important in the state, not only as infrastructure, but also as a key fiscal resource. First, judicious exploitation of this resource would contribute significantly towards **alleviating the power shortage** in the northern grid, and provide a source

of "green energy". In contrast to the north-east region of the country, which also possesses great hydropower potential, HP is relatively close to the major demand centers of Northern India, which strengthens its competitive position as a supplier, especially in summer when it has a surplus. Second, more importantly, it could also be a major source of **non-tax revenue for the government** as royalty for the use of state water resources in the form of royalty power from hydropower projects. Revenue from the development of its hydropower potential, assuming efficient project implementation and sound fiscal management, could help restore fiscal health. This revenue, which has already started flowing in as described earlier, could provide significant resources for the development of infrastructure and provision of social services.

HP's power sector has a number of notable features. About 95–97 percent household have access to electricity, compared to the national average of 88 percent for urban and 44 percent for rural households, and almost all villages are electrified (Figure 4.1). The pace of hydropower development has gone up over the last few



Figure 4.1: Untapped Potential in Hydropower, but Good Outcomes in Power Connectivity



years and the momentum is expected to increase further as new projects are developed. There has been good experience in the first few years of economic regulation of the sector, including a functioning independent regulator,<sup>49</sup> an improved consumer grievance redressal mechanism, enhanced public hearing procedures, and the introduction of economically sound tariff-setting principles. The policy framework for the development of the power sector is clear in its general orientation, with a significant role assigned to public sector developers—but also including policies to attract private investment to hydro projects of various sizes. The Himachal Pradesh State Electricity Board (HPSEB), a public body created in 1971 under the Electric Supply Act (1948), continues to have monopoly in the electricity transmission, distribution, and supply business.

## Hydropower as a Key Fiscal Resource

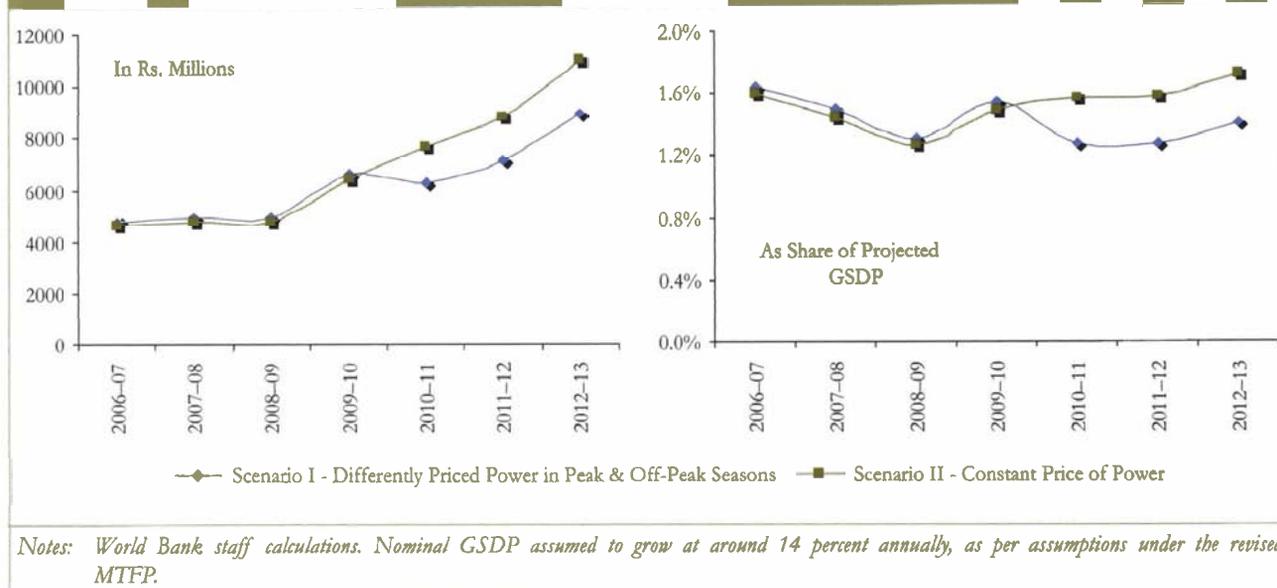
GoHP has various mechanisms in place to harness fiscal resources from the generation of hydropower.

The state has followed a *mixed model of development* of the state's hydropower resources through: (i) the state sector, by HPSEB directly; (ii) central companies like the National Hydroelectric Power Corporation (NHPC) and National Thermal Power Corporation (NTPC); (iii) Joint Venture (JV) with GoI (SJVN); and (iv) private sector companies like the Jay Pee and Bhilwara groups. GoHP is entitled to earn royalty, in the form of 12 percent of power generated by the project free of cost, for the use of its water resources by the hydropower projects. HP has recently notified a new *Power Policy* with special emphasis on accelerating the development of the untapped hydropower potential through both public sector developers as well as private investment. Under the new Power Policy of GoHP, the royalty fee to the state from hydropower projects has been fixed at 12 percent of power generated by the project free of cost for the first 12 years of project operation, 18 percent of power generated by the project free of cost for the next 18 years, and 30 percent of power generated by the project free of cost after 30 years of project operation. Subsequently, after 40 years of operation, the

<sup>49</sup> Himachal Pradesh State Electricity Regulatory Commission (HPERC) was constituted in 2000 and became operational in 2001. It is a single member commission. It has issued five tariff orders till date, the latest one being in April, 2007.



Figure 4.2: Projected Revenues from Royalty Power



project reverts back to the state free of cost. The state has also retained the right to take up equity in the new hydropower projects. In case of the JV, in addition to the 12 percent royalty power, GoHP also has an entitlement of additional power proportionate to their equity stake at the regulated tariff that it can either use within the state or sell to other states.

The revenue earned through the sale of royalty and equity power that has already started flowing in is expected to provide significant resources to the state in the coming years. The potential of this sector to generate future revenues for the state government cannot be over-emphasized. Basic back-of-the-envelope calculations indicate that the HP is expected to earn about Rs. 9–11 billion in revenue by 2012–13 through royalty power from its planned and existing hydropower projects, based on two scenarios—one where power generated during peak and off-peak hours is priced differently, and another where there is a single price for power (Figure 4.2). This is more than 37 percent of the state's current level of own revenue receipts, and more than double HP's current level of own non-tax revenues. Revenue from power would be between 1.4 to 1.8 percent of

GSDP in 2012–13, assuming an annual nominal GSDP growth rate of about 14 percent, as per assumptions under the revised MTFP. Furthermore, there would be additional earnings from power sold from the share of GoHP's equity in the Nathpa Jhakri Hydro Project which is under operation, and the Rampur Hydro Project which is under construction. The returns would vary depending upon the ruling price of bulk power.

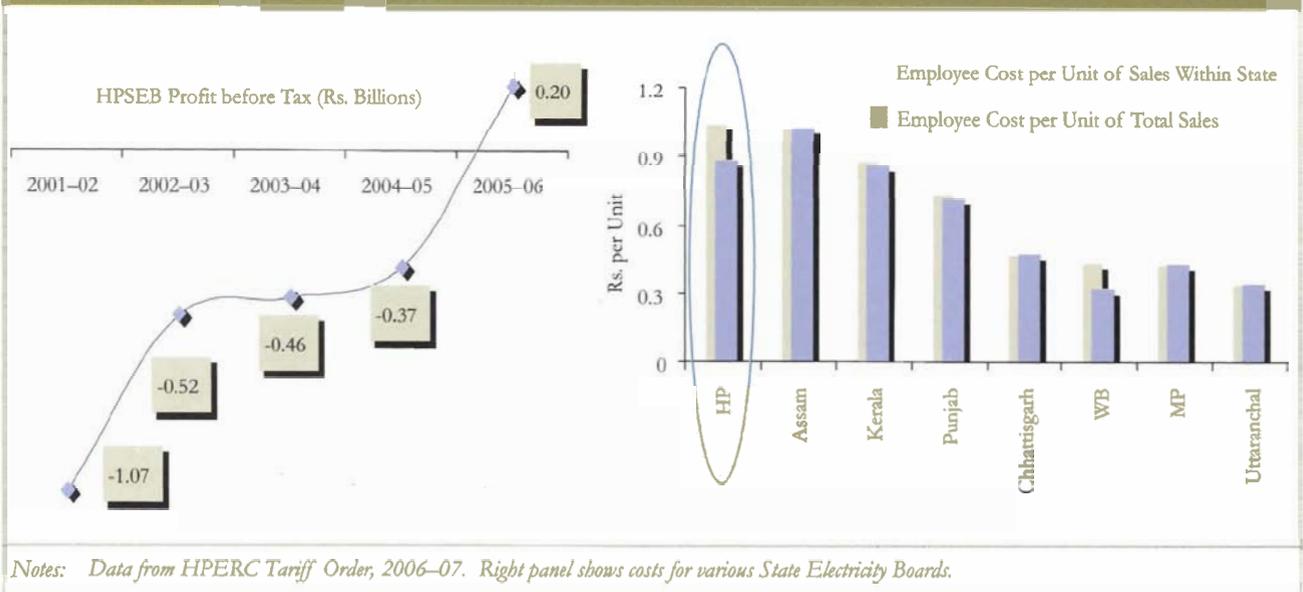
## Key Challenges and Policy Options

There is considerable untapped potential in the sector, and only about 32 percent of the potential has already been developed, and construction has started on another 21 percent of total potential. GoHP has estimated that, by the end of the Eleventh Plan, some 43 percent of the potential could be in operation. However, hydropower development in the Himalayas involves considerable risks, and states, including HP, have a modest track record in the implementation of hydropower projects on their own.

The sector faces various challenges with regard to the institutional structure and internal efficiency of the



Figure 4.3: Financial Challenges facing HPSEB



HPSEB, and the power trading strategy. The number of new hydro projects involving various public and private players that are expected to come up in the state underscores the importance of proceeding expeditiously with the fundamental restructuring of the sector; lack of clarity in such matters is detrimental to the investment climate. The state can take the following steps to support expansion of this sector.

- It is important to enhance the **internal efficiency** of the HPSEB. The HPSEB was actually suffering financial losses, until it achieved a surplus in 2005–06 (Figure 4.3). HPSEB’s financial health needs to improve to ensure that the utility is able to continue to provide for the long-term maintenance of the system, and reliable power to consumers. It is important to control costs, arising from: (i) high interest payments on HPSEB’s outstanding debt of Rs. 26.35 billion in 2005–06, while debt servicing was Rs 4.69 billion, or 26 percent of total revenue;<sup>50</sup> (ii) Transmission and Distribution losses of

around 23 percent in 2004–05 which, though relatively low, could be reduced further; and (iii) an employee/kWh-sold ratio which is among the highest in India (Figure 4.3).

- The sector is in need of **institutional restructuring**. HP must comply with the Electricity Act (2003), under which states were given one year to restructure their state electricity boards by segregating the transmission function from the power trading function.<sup>51</sup> Although GoHP had received an extension until December 2006, it is yet to decide on a blueprint for restructuring HPSEB. However, HPSEB is in the process of separating its accounts into the three segments of the power supply chain (generation, transmission, and distribution). It is important to design a restructuring plan for the power sector and implement it as early as possible, incorporating the experience from similar states that have restructured—like Uttaranchal. It will also be imperative to ensure that the boards of

<sup>50</sup> The Debt Service Coverage Ratio (DSCR) has improved from 0.03 in FY2002 to 0.49 in FY2006.

<sup>51</sup> Despite an extension till December, 2006, GoHP has not yet come up with a restructuring plan.



the restructured entities are given autonomy, and include a mix of non-executive and independent directors in line with the principles of good corporate governance.

- The **human resource profile** needs to be addressed if it is not to have a negative impact on the sector's future performance. Though HPSEB currently has staff strength of slightly more than 26,000 adding to costs, it faces an acute shortage of the professional and technical skills needed to meet the demands of the sector and the changing business environment. It will be critical for the sector's efficient performance to carry out a human resources need and skill assessment, and develop/implement a plan to meet the emerging new sector structure and evolving business environment.
- It is important to adopt a **clear power trading strategy**, given that revenues expected from the sale of hydroelectricity constitute a significant portion of the state's planned revenue for years to come. As most of the electricity will be sold outside the state, it will be important to adopt a strategy that will maximize for the state the benefits of this trade—based on an analysis of actual and expected future market conditions, taking into account expected dynamics of supply and demand in different regions in India, especially in the Northern Region. A useful first step for identifying the optimal strategy for HP would be to carry out a detailed assessment of the market, and the implications of different trading strategies (e.g., taking an equity exposure in projects, setting up a separate trading company distinct from HPSEB, going in for short term or long term contracts for sale of power, meeting the state's demand during winter months when there is a deficit, etc.).
- The **bidding process** for new hydropower projects is not in conformity with national policy. The current practice is of financial loading on hydro projects through up-front bidding charges, earmarking a percentage of the project cost for local area development, and assessing an increasing level of revenue as

royalty from free power (for use of the state's water resources), against the policy mandate of going in for tariff-based competitive bidding. While this is the essence of the benefit of hydropower development to the state, this approach needs to be carefully evaluated in terms of the risk it could pose to the overall trading plans of the state—given the large capacity addition being planned by power-surplus states (north-eastern region, Uttaranchal, Orissa, West Bengal) and the ultra mega projects being planned by GoI. These charges will inevitably put upward pressure on tariffs for end-consumers and may make the projects less attractive or difficult to finance. The current practice of awarding potential hydro projects on the basis of upfront charges could be revised to tariff-based competitive bidding, in line with the national policy.

- GoHP has recently set up a **new generation company**, the Himachal Power Corporation, to undertake implementation of hydropower projects in the state to operate in the manner of the central public sector power corporations. It has been proposed that a number of new projects that had been either earlier allocated or are still unallocated be transferred to this new entity. This new approach can have significant implications for the state on account of: (i) possible *crowding out* of funding for priority sectors with the state's resources getting tied up for contribution to equity or raising debt for development of the new hydropower projects; (ii) limited *resources and capacity* of the state to undertake the new projects, thereby slowing the pace of hydro development; and (iii) the possible need for GoHP to bear the *off-take and pricing risk* for the power generated from these projects, especially considering the very competitive tariffs projected from the proposed coal-based ultra mega projects which are easier to implement. It would be worthwhile for GoHP to strategically evaluate the risks involved under this model, in comparison with the corresponding benefits depending on the different approaches that are possible.



Of particular importance is the need to exploit the state's hydropower resources in a sustainable manner. Injudicious exploitation of these resources could have implications for the future availability of hydropower resources, for the societies and communities affected by hydropower development, and for the wider environment. This critical aspect of hydropower development is discussed subsequently.<sup>52</sup>

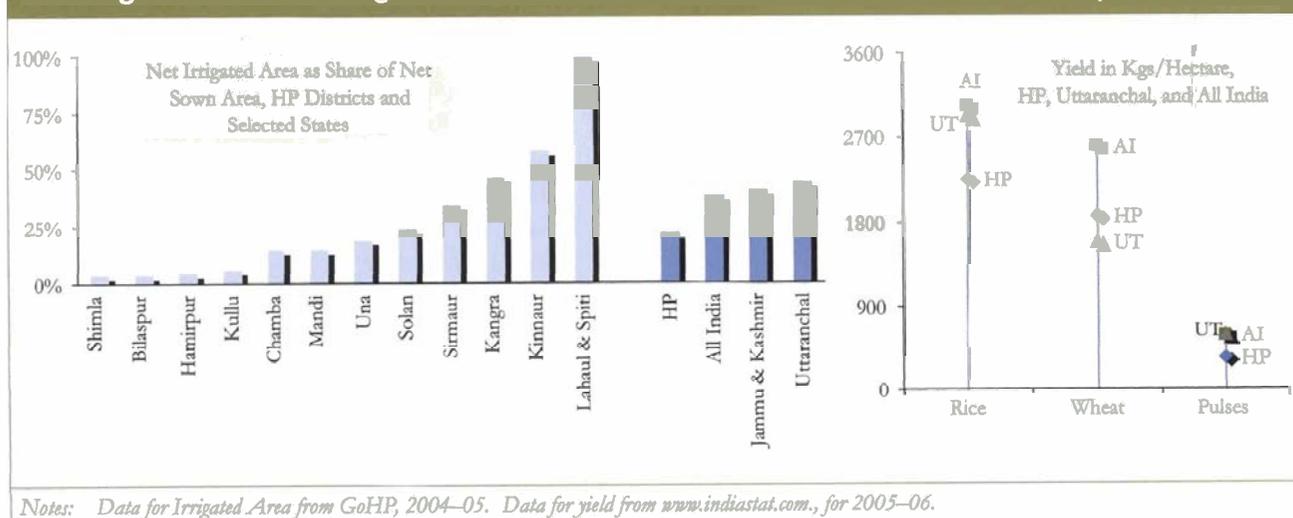
## B. Promoting High Value-Added Cultivation in Agriculture and Allied Sectors

The agricultural sector faces several challenges. The average holding size is about 1.2 hectares, which is about 80 percent of the national average holding size, with over 92 percent of holdings classified as small or marginal. Crop yields are constrained by per hectare fertilizer consumption that is half of national averages. The average yield of most food crops is lower than national averages, and, although it compares favorably

with other hill states, the yield is lower than in the states in the plains (Figure 4.4). Irrigation facilities are particularly under-developed, with more than 77 percent of the net sown area in the state being unirrigated, compared to 61 percent nationally. Other constraints are limited access to technology and markets, and poor management of soil and water.

However, despite constraints imposed by the terrain, there are considerable opportunities to diversify away from traditional cereals and pulses to horticulture, floriculture, and high value fruits suited. The state's varied climate and topography can support sub-tropical and temperate climate fruits like mangoes, litchis, guavas, and apples, while cultivation of strawberry, pomegranate, olive, kiwi, and hazelnut has been introduced. There is also potential for mushrooms, flowers, medicinal/aromatic plants, and bee-keeping. The state will also need to focus on improving animal husbandry, since HP is endowed with a large livestock population, which is a major source of livelihood in the alpine areas. The livestock population of over 5 million contributes milk, wool, eggs, and meat.

Figure 4.4: Low Irrigated Area and Low Yield of Traditional Food Crops in HP



<sup>52</sup> See Chapter 7.



## Departmental Vision for Various Sub-Sectors

The Department of **Agriculture** has developed a strategy to achieve the basic objectives of increasing income generation and job opportunities for farming communities through diversifying agriculture, value addition, and providing support for post-harvest activities. The main activities proposed are: (i) improving availability of quality seeds; (ii) increasing fertilizer inputs; (iii) better use of water resources through conservation and rainwater harvesting, and more efficient water use; (iv) promoting organic farming, including use of bio-fertilizers; (v) supporting an improved system of post-harvest handling, storage, and marketing; (vi) diversifying from traditional cereal crops into higher value vegetables, spices, and seed production;<sup>53</sup> and (vii) developing tea cultivation and processing in Kangra. The Department is also active in promoting small-scale irrigation, and is successful at transferring 1,500 to 2,000 hectares of irrigated land to registered water user groups, without imposing a fiscal burden on the State.

The overall strategy of the Department of **Horticulture** is also to improve income generation and employment opportunities for farmers through modernization of production technologies and greater emphasis on post-harvest activities. Some of the important steps taken by the state include: (i) improving quality of planting material through research and development, modernization of nursery production, and change from low to medium and high density plantation; (ii) encouraging organic farming through use of bio-fertilizers and bio-pesticides; (iii) introducing high-technology cultivation through micro-irrigation; and (iv) attracting private agencies for post-harvest processing and marketing, through liberal policies and basic support under the restructured “HP Agricultural and Horticultural Produce Marketing

(Development and Regulation) Act 2005”. The state has taken several important steps to encourage private participation in post-harvest activities.<sup>54</sup>

The Department of **Animal Husbandry** has a policy to support natural breeding for remote areas, and has started providing door-step delivery of Artificial Insemination at subsidized prices from 2003. In addition, the department is providing veterinary services through a network of 2,070 veterinary institutions, which include 7 polyclinics, 328 veterinary hospitals and dispensaries, 14 mobile veterinary dispensaries, and 1,721 veterinary dispensaries. The HP Livestock Development Board has been set up to improve the animal husbandry services in the state, while HP MILKFED is operating dairy development activities in the state by providing remunerative outlet for surplus milk.

## Strategic Options to Achieve the Vision

The state needs to take steps to energize this sector, especially given its importance as a source of livelihood for poor rural communities. This will require close collaboration with the private sector in post-harvesting activities, and improving the infrastructural requirements for the sector—especially in the form of irrigation and rural access. Government may consider the following measures.

- While not enormously important in fiscal terms, it is important to rationalize subsidies provided through the departments of Agriculture and Horticulture according to the principles of: (i) discontinuing or drastically reducing subsidies on traditional practices to free up funds for proposed new activities such as diversification, value addition, grading, packaging, processing, and marketing;<sup>55</sup> (ii) making subsidies sustainable,

<sup>53</sup> About 2,100 hectares is proposed to be diverted under these crops during the Tenth Plan.

<sup>54</sup> Recognized large establishments like the Adani Group and others have established Controlled Atmospheric Storages in the state. Storage capacity of 18,000 tons has already been established by the private agencies and has started working from the current year. This is over and above the efforts of organizations like Himachal Pradesh Marketing Cooperation (HPMC) and Agro Industrial Packaging India Limited (AIPIL).

<sup>55</sup> There are no more subsidies by the Department of Agriculture on pesticides, and the fertilizer subsidy is reduced to Rs 10/bag for every farmer.



possibly through one-time support for new activities; (iii) enhancing consistency between strategy and state policy, by, for example, reducing subsidies on fertilizer and pesticides where organic farming is encouraged, and freeing funds for the use of bio-fertilizers, bio-pesticides, and Integrated Pest Management; and (iv) improving targeting of subsidies to poor and marginal farmers by identifying activities generally undertaken by them. In the animal husbandry sector, the subsidies on medicines for curative measures should be dispensed with, and funds used more vigorously for protective measures against possible outbreaks and community activities—such as de-worming.

- The state should re-examine its land policy to facilitate cultivation of land on a lease basis. At present, the owners keep agricultural land fallow instead of giving it on lease due to fear of losing ownership.
- In order to modernize extension services, the state could consider steps towards: (i) making better use of NGOs and farmer associations for training; (ii) organizing refresher courses for staff to orient them to the needs required to implement the state strategy, and utilizing the services of the two universities at Nauni and Palampur to effectively train the trainers; (iii) developing skills in modern communication, by effectively using mass media; and (iv) making the best use of available staff through a multidisciplinary approach wherein competent and trained staff services are used exclusively for technological dissemination. Under the present extension system, in agriculture in particular, there are vacancies at the grass-roots levels, and this makes reorganization of the system particularly important.<sup>56</sup> The Department of Horticulture should also upgrade the capacity and skills of its staff under the Horticultural Technological Mission's scheme, through stronger efforts in this direction.<sup>57</sup> For animal husbandry activities, there is one extension representative on average for 1–2 GPs. The number should be reduced, while alternatives like para-veterinarians are trained, and the capacity and quality of existing staff improved through refresher courses, modern technologies, and upgrading communication skills.<sup>58</sup>
- Despite steps to improve post-harvest processing and marketing, results are still not visible for perishable products like vegetables and flowers cultivated by small farmers. There is a clear understanding in the Department of Horticulture that only private agencies can effectively take up processing, value addition, and marketing of produce—and this is also the policy of the state. A detailed critical study could be conducted to identify the constraints in production of high value crops (especially medicinal and aromatic plants), and inhibitions of the private agencies in taking up the processing and marketing should be addressed based on study findings. The Department of Agriculture also has a strategy to facilitate marketing, but this is not adequately reflected in the 2006–07 budget.<sup>59</sup>
- The state can invest in research to improve productivity. The universities could particularly

<sup>56</sup> Under the present extension system, the grass-root level extension workers are Agricultural Extension Officers (AEOs) with eight in each block. Since there are 50 percent vacancies there exists about 4 AEOs in each block, covering 10 to 12 Gram Panchayats (30 to 40 villages). Added to this, each AEO has to perform several other activities related to input supply and implementation of other schemes.

<sup>57</sup> Horticulture got an important boost with the commencement of the Horticultural Technological Mission in 2003–04, with a vision towards privatization, diversification, value addition, marketing, organic farming, technological innovations, and improved productivity.

<sup>58</sup> The department of Animal Husbandry continues to subsidize the cost of Artificial Insemination (AI). The price was raised from Rs 5 to 15 per AI in compliance of the commitment under the Bank-financed watershed project. Looking to the successful door-step delivery which cost an additional Rs 35 to 40 per AI, it can be said that the farmers are willing to pay for good and timely services. This service is presently provided by the Veterinary Pharmicists working with the veterinary doctors. If they are provided with sufficient training they can also provide the health services. This makes a strong case for identifying and training the village youth to work as para-vets (not as government employees) under the supervision of the veterinary doctors. A similar approach can be followed for providing bulls for natural breeding to the community on nominal price maintained by an individual/community by charging for service and under the supervision of the veterinary doctor.

<sup>59</sup> The department explains that the infrastructure development for marketing is largely taken care of by, first, marketing boards which collect the marketing fees for the produce and, second, to some extent by the Government of India schemes. However, this does not meet the basic strategic need for facilitating the processing and developing marketing linkages to the value-added products.



help in getting the quality planting material—especially exotic patented germplasm—to improve horticultural production. In animal husbandry, there is shortage of quality pedigree bulls for Jersey and Holstein cows, and also for Murrah Buffalo required for cross breeding. This should be resolved by acquiring high quality animals to be maintained and multiplied at the University research farms, and modern establishments in Palampur and Nalagarh should be effectively utilized for this purpose.

- ~~Diversification of horticulture in the state is currently largely confined to apples, even though there is potential to expand more aggressively into other fruits and vegetables. Hence, it is important to look effectively beyond fruits—in particular, apples, which may soon be overwhelmed by Chinese production. This requires more effort across the spectrum, from production (identification of crop, availability of quality seed/planting material, and packaging practices) to processing and marketing (through private agencies).~~
- The state already has several thousand farmers who have been certified as organic producers by three agencies. In order for more farmers to get an attractive price for organic horticultural produce, the state should extend promotion of organic certification, and could offset some of the up-front costs (certification as well as compensation for low yields) normally associated with converting to organic production.
- Sectoral policies should be harmonized across the state, and not be based on projects/programmes funded by specific agencies. Activities are often uncoordinated across GoI and donor-funded schemes, and attempts could be made to adjust to the need of the state and the state policies.<sup>60</sup> The recently established, “Natural Resource Management Society” under the chairmanship the Chief Minister as a part of the World Bank-financed “Mid-Himalayan Watershed Development Project” could provide an excellent forum for this purpose

with suitable modifications in its by-laws which are already under consideration of the GoHP.

- There needs to be better collaboration, especially among the primary sector departments, to address the strategic issues which can not be resolved by any one department. This is particularly true of coordination with the Department of Irrigation and Public Health (IPH) for the creation and management of minor irrigation schemes. In addition, there are several areas of overlap between the Departments of Horticulture and Agriculture that can be rationalized.

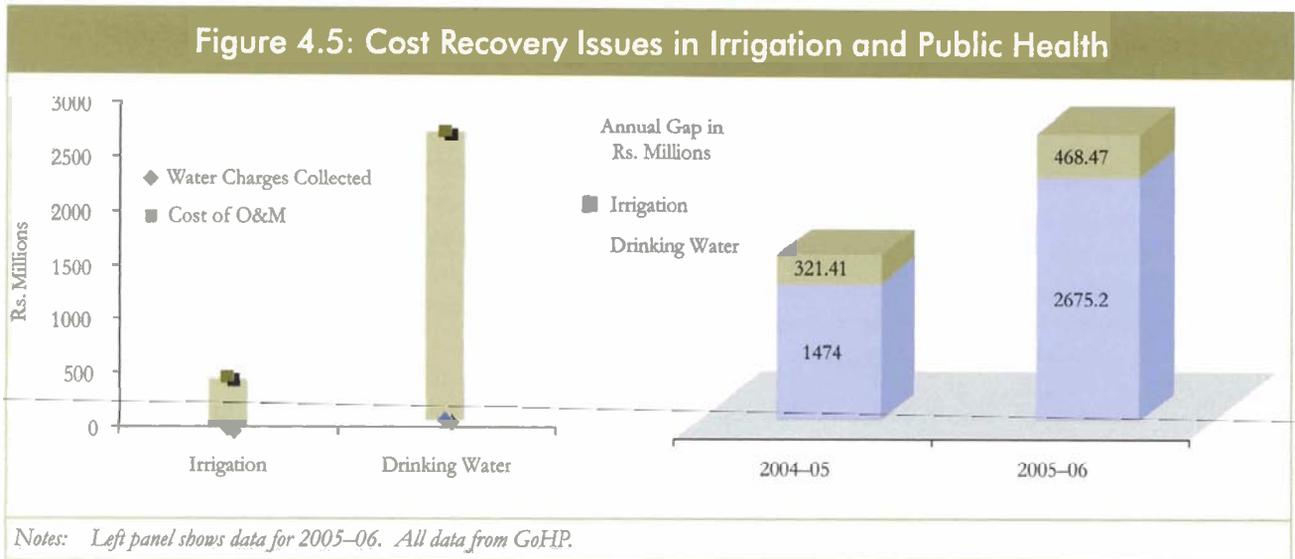
## Improving Irrigation and Water Supply

Performance in the irrigation sector has direct relevance for primary sector growth, but there is considerable unrealized potential in this sector. HP is home to high ranges of the Himalayas with snow and perennial glaciers which supply water to much of northern India and beyond. While there is no overall scarcity of water, only 22 percent of the state's net sown area is irrigated. Of the irrigation potential of 0.33 million hectares, only 0.21 million hectares is assured of supply. At least another 50,000 to 90,000 hectares can be brought under irrigation by completing ongoing projects and introducing new schemes. .

While most of the state's progress with farmer-managed schemes has been made by the Department of Agriculture, most irrigation, as well as drinking water supply, lies in the domain of the Department of Irrigation and Public Health (IPH). A major policy issue in IPH is a huge gap between funds collected for irrigation and drinking water schemes, and the cost of operating and maintaining these schemes. This wide gap is due to a near-zero rate of drinking water charges, coupled with very low charges for both flow irrigation and lift irrigation. The aggregate shortfall has significantly increased in recent years (Figure 4.5). In 2005–06, the aggregate shortfall was almost Rs. 3150 million.

<sup>60</sup> Such flexibility already exists to some extent in the Horticultural Technological Mission programmes but other examples are rare.





The state appreciates the challenges in improving irrigation facilities to promote primary sector growth and ensuring a safe supply of drinking water for households, and is now taking important steps to devolve control (and costs) of both services to beneficiary groups. This is seen as a way to improve efficiency and quality. Guidelines have now been prepared to transfer total or partial responsibility of drinking water schemes to Gram Panchayats. Similarly for irrigation, IPH has drafted guidelines to transfer responsibility of tertiary canals or small schemes to water user groups, in a manner already employed by the Department of Agriculture. This change is recognized as one that requires substantial capacity-building and sensitization for beneficiaries and IPH staff alike, and piloting is set to begin within the year.

The Department of IPH could consider and build on other reform measures. Some of these reforms are important from the perspective of fiscal recovery and better service delivery.

- **User charges**, which are among the lowest in the country and cover only about 2.3 percent of required O&M expenditures, have to be increased despite expected popular resistance, through: (i) accepting in principle that O&M cost recovery has to be met through service

charges; and (ii) gradually increasing costs through advance announced amounts to reach full cost recovery level.

- The Department of IPH is **overstaffed**, with 30,704 staff (including 3,823 permanent). Most of these staff are underutilized; two-thirds of the non-regular staff are “key men” who are paid to turn drinking water taps on and off. The state could gradually reduce staff strength, and hand over the responsibility of O&M to Gram Panchayats or communities. IPH is considering adding a maintenance function to the responsibilities of the key men, which would increase their cost effectiveness.
- The state has already announced a **participatory strategy** involving beneficiaries and GPs to participate in planning and execution of the irrigation and drinking water schemes. This could be practiced for all new projects wherein the government provides technical and one-time financial support to the GPs or beneficiaries to develop their own water resources.
- The IPH Department intends to adopt a **multidisciplinary approach**, to develop and utilize the water resources with representation from other departments like Agriculture, Health, Rural Development, Power, and Forestry. This



would help foster coordination, learn from best practices, and avoid unnecessary duplication.

## C. Developing the State's Tourism Potential

Tourism is an important labor-intensive sector where the state has potential due to its environmental, climatic, and natural heritage. Given that it offers visitors excellent exposure to temperate forests, HP can be an ideal area for activities like trekking, safaris, rock climbing, nature walk, angling, camping, etc.—thus signifying the possibilities of nature tourism, eco tourism, and adventure tourism. GoHP specifically recognizes that tourism is a sector that can prove vital to the state's long term growth and employment prospects—largely on account of tourism being a labor

intensive sector where HP has immense potential on account of its environmental, climatic, and natural heritage. The sector also has the potential to absorb educated workers—Planning Commission estimates show that an investment of Rs. 10 lakh in tourism creates 47 jobs, making it particularly important in the context of HP's stated objective of creating productive work opportunities for educated workers.

In spite of these advantages, the sector's performance leaves something to be desired. Recent growth rates calculations show that the sector has been growing at an annual rate of about 6.3 percent since 1993–94—which is slower than the sector's national growth rate of almost 8 percent. Even though HP is one of the few Indian states receiving *tourist inflows* per year greater than its total population of 6 million, this contributes a small share of tourists to India (Figure 4.6). Moreover, the state faces challenges in terms of attracting

Figure 4.6: HP's Challenges in Tourism

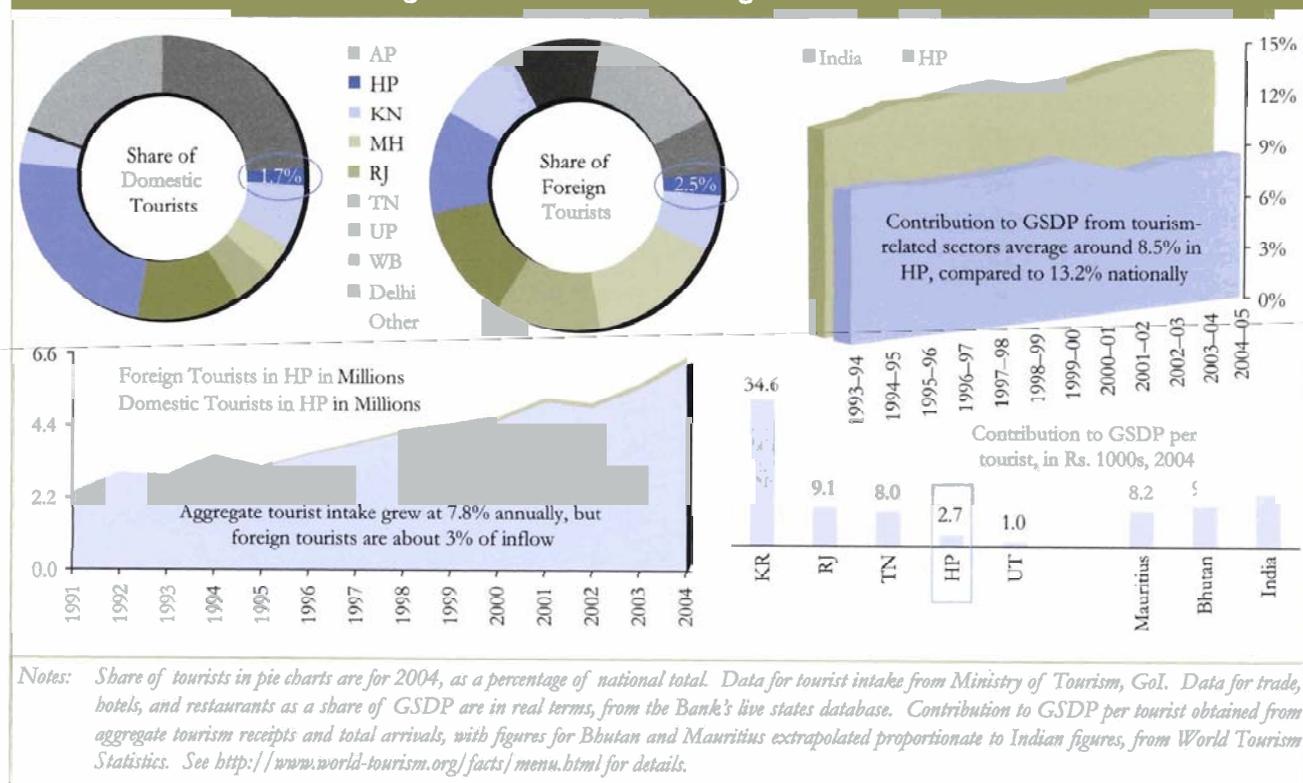
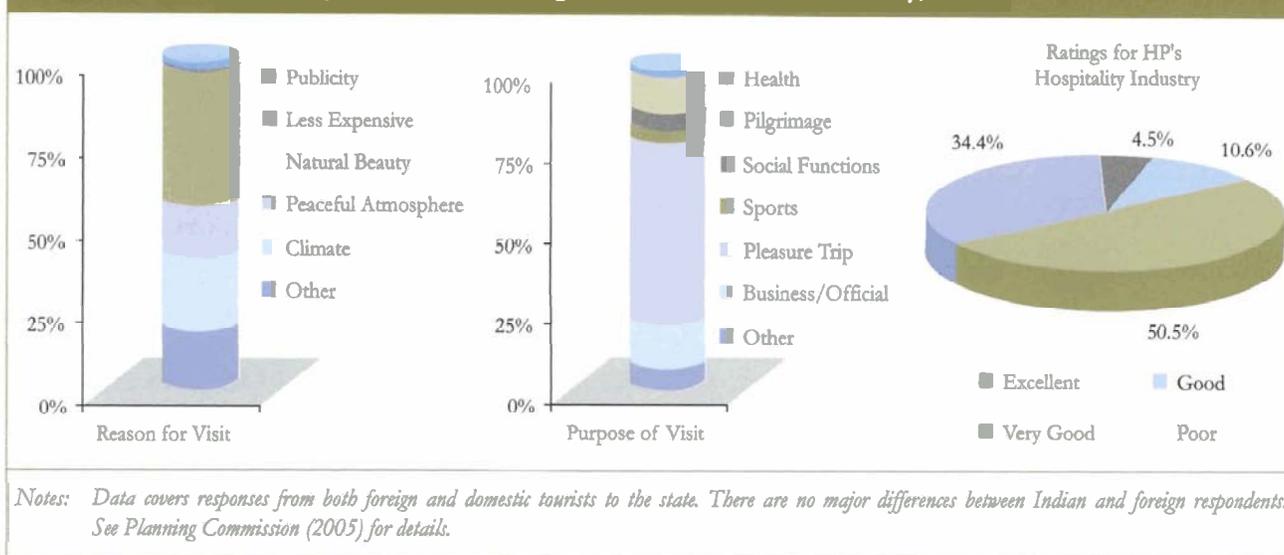


Figure 4.7: Findings from HP Tourist Survey, 2002



high-end tourists and providing them with experiences to rival international destinations. Intakes are confined largely to low-end and domestic tourism, while foreign tourists account for only 3.1 percent of annual intake. This is better than the national average of 2.3 percent foreign tourists in 2004, but states like Kerala have achieved higher shares of foreign tourists like 5.6 percent. Domestic tourists tend to spend a lot less than foreign tourists—suggesting that attracting foreign travelers may be one way of increasing sectoral revenues. According to a 2003 study, the average per capita expenditure by a domestic tourist, in HP, for a 3-day stay is Rs. 4988 while the corresponding figure for a foreign tourist is Rs. 11318. In terms of contribution to GSDP, the trade, hotels, and restaurants sub-sector related to tourism contributes about 8.5 percent of GSDP at present. On a per-arrival basis, this contribution works out to be lower in HP than nationally, in more developed states like Kerala and Tamil Nadu, and in small countries which have worked on developing their tourism potential—lending credence to the theory that tourism in the state is largely low-value (Figure 4.6). However, HP is doing better than other hill states like Uttaranchal—where the sub-sector contributes only about 6.6 percent of GSDP, and about Rs. 1039 per

tourist annually, and foreign tourists are only about 0.5 percent of annual inflows.

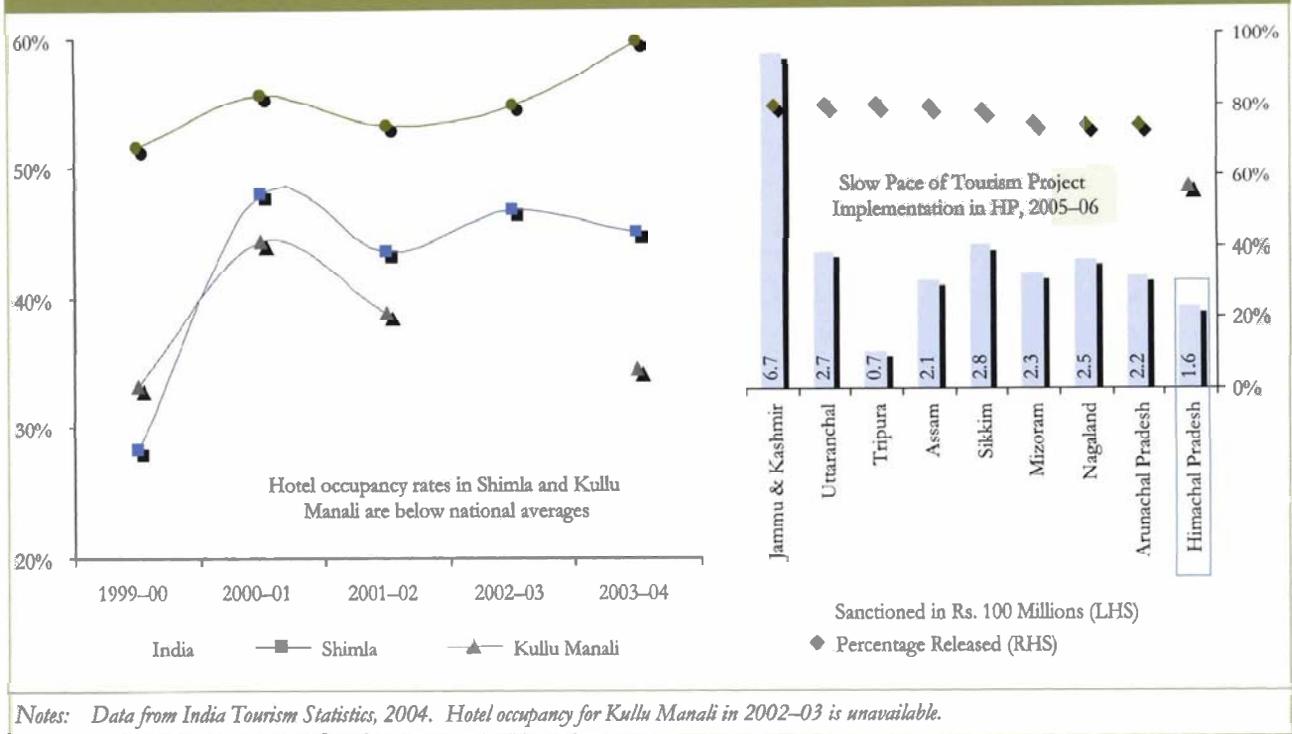
Some preliminary analysis of over 8,000 tourists to the state in 2002 suggest that almost two of every three tourists are attracted to the state because of its natural beauty and climate—highlighting the importance of preserving the state's environmental heritage (Figure 4.7). However, less than 2 percent of tourists had been drawn by information and publicity, suggesting that HP is not doing a stellar job of marketing itself as a tourist destination. Most visitors to the state come on pleasure trips—but avenues for health-related tourism and sports or adventure tourism could be exploited further. The hospitality industry is not rated too highly by respondents, with an average rating of about 2.5 on a 4-point scale along dimensions of behavior, food and drink, and cleanliness of accommodation (Figure 4.7).

### Constraints to Development of Tourism

The sector faces several constraints. First, **poor connectivity**—including underdeveloped road networks, and small airports unsuited for major



Figure 4.8: Constraints to Development of Tourism Potential in HP



commercial airlines—are major constraints to the sector's development. The airports at Shimla, Dharamshala, and Kullu are not well-connected to other Indian cities, and adequate only for 18-seater aircraft. There are 56 helipads in the states, but they do not provide regular commercial services. An average tourist from Delhi can reach Singapore or Bangkok in half the time required to reach Shimla. Second, facilities are inadequate, especially for high-end tourists. The state has only four five-star and deluxe hotels—in Shimla, Mashobra, and Kullu Manali—which can cater to high end tourists, and this is reflected in Shimla and Kullu districts together accounting for about half of tourist inflows annually. Safety standards and facilities provided in the informal sector motels and lodges are

generally poor. However, hotel occupancy rates are still lower than nationally, partly due to connectivity issues (Figure 4.8). In addition, while there were 223 travel agents, 308 tour operators, 175 tourist transport operators, and 13 adventure tour operators registered with the Ministry of Tourism nationally in 2004, there was not one recognized operator in HP.<sup>61</sup> Third, HP lags similar hill states in terms of **new tourism projects** under implementation, and even the pace of implementation of these initiatives is slow (Figure 4.8).<sup>62</sup> Fourth, tourism faces challenges in **factor markets**—in terms of lack of skilled labor and access to ready credit for capital intensive and long gestation projects. GoHP is still to transfer designated available land in a few important places to the Tourism Department, as

<sup>61</sup> States like Andhra Pradesh, Kerala, Karnataka, Maharashtra, and Tamil Nadu do well in this respect, but even hill states like Uttarakhand, Nagaland, and Jammu and Kashmir have registered operators. See India Tourism Statistics, 2004, for details.

<sup>62</sup> As per GoI data, there were four tourism projects approved in HP in 2005-06 with a sanctioned amount of Rs. 160 million—of which 56 percent was released, compared to a national average of 75.5 percent. See India Tourism Statistics, 2004, for details.



per agreement.<sup>63</sup> Fifth, there is **lack of an integrated approach** in the implementation of the state's tourism strategy. Inter-departmental coordination in this sector is particularly important since the work of various departments—including Urban, Town and Country Planning, Civil Aviation, Roads, Environment, Power—has direct implications for the realization of the tourism potential of the state. Sixth, the role of the state-run HP Tourism Development Corporation (HPTDC) also remains unclear. Unlike in Rajasthan, the state continues to run HPTDC, and while the lack of funds prevents the state from upgrading the facilities at the HPTDC properties, it also prevents the private sector from operating some of these prime properties more profitably.

## State Vision and Recent Developments

GoHP's stated objective is to develop the state's tourism sector as a prime engine of economic growth, and to position itself as a major global destination by 2020. The state has a *Tourism Policy* in place, issued on June 6, 2006. The target is to increase the contribution of tourism to GSDP to 15 percent by 2020. This Policy has some good thinking and the right statements of intent. It focuses on developing better inter-sectoral coordination, upgrading infrastructure facilities, marketing HP effectively as an attractive tourist destination, investing in training for tourism services, and promoting activity-based tourism. In particular, the Policy recognizes the need to promote the private sector, and strengthen tourism in an environmentally sustainable manner. However, implementation is behind schedule—and the Policy needs to clearly define financial targets, achievement targets, and modes of financing.

GoHP has taken steps to improve *eco-tourism*. Ecotourism projects are located on forest land under the Department of Forests, which has already

formulated an Eco-tourism Policy in consultation with the Department of Tourism—with a view to developing eco-tourism in an ecologically sustainable way. Eco-tourism societies have been established on a Community Based Eco-Tourism (CBET) basis to cover the Greater Himalayan National Park (Kullu), Himalayan Nature Park (Shimla), Potter's Hill Van Vihar (Shimla), Renuka Wildlife Sanctuary (Sirmour). Further development of eco-tourism sites—along with private parties—in an environmentally sustainable manner (including charging fees for maintenance) are part of GoHP's longer term plans. GoHP already charges a “green fee” from tourists to Manali. It plans to introduce this in other tourist destinations, and use the funds so collected for environmental conservation activities in ecologically vulnerable tourist areas.

A multi-departmental *HP Tourism Development Board* (HPTDB) has been set up under the chairmanship of the Chief Minister, to promote the sector—and it was operationalized in 2005 with a view to minimizing bureaucratic hurdles in tourism development. The HPTDB is supposed to formulate policy guidelines for tourism development, and advise GoHP on matters relating to regulation and licensing. The Tourism Policy recognizes that tourism development in HP is underfunded relative to other states, but better coordination and integration among departments including Public Works, Transport, Irrigation and Public Health, Power, Forests, Environment, Urban Development, and Town and Country Planning—which can contribute to better infrastructure and civic amenities—will help tourism development. The state hopes to achieve this through the HPTDB, which has representation from various line departments.

In the area of *regulation and clearances*, in order to minimize bureaucratic delays for the private sector, GoHP has introduced single window clearance for tourism projects. However, the system has to be

<sup>63</sup> Since 70 percent of land is designated as forest land, this limits availability of land for development projects. Amendment of Section 118 of the HP Tenancy and Land Reform Act has helped institutional developers to acquire land in HP.



made more efficient to attract more investment. The HP Registration Tourist Trade Act was passed in 2002, in order to allow for checking and inspecting hotels and travel agencies against over-charging or substandard services. GoHP also plans to promote tourism through strengthening the capacity of Hotel Associations to conduct inspections, classifying tourist units by facilities provided to ensure value for money to tourists, and strengthening Tourist Police by training 500 police and home guards in tourism-related matters like safety for tourists. The major development in the state's tourism sector during 2005–06 is the approval of the largest Foreign Direct Investment project in the tourism sector in India, worth \$135 million, to develop the Himalayan Ski Village Project near Manali, with a total project cost \$300 million. This project is expected to be implemented during the next three years, and once operational in 2009, is projected to yield GoHP about Rs.1.0–1.2 billion in revenues over the next 10 year period.

Recent steps have been taken to improve *air connectivity*. The airports at Shimla, Dharamshala, Patahankot, and Kullu are not well-connected to other Indian cities, and can take ATR 42 aircraft. There are 56 helipads in the states, but they are not used for regular commercial services. Moreover, travel time from Delhi to Singapore or Bangkok is half of that required to reach Shimla by surface transport. In order to overcome this constraint, the government is looking to improve air connectivity. The Airlines Authority of India has opened the expanded runway and new terminal of Kangra Airport at Dharamshala, and Air Deccan (a major domestic airline) has operated its first flight in April, 2007. The runway of the Kullu Airport is to be expanded by building a bridge on a river near the terminal, and connecting it to the runway. An airport is planned at Mandi. Since expansion of airports are a medium term option requiring financial resources, encouraging regular helicopter and chartered flights—especially in conjunction with major private hotel chains—are also part of GoHP's plan to improve accessibility.

#### Box 4.1: Kerala's Approach to Tourism Development

Kerala has been the most successful state in India in positioning itself competitively in the international tourist market. In 2003, it recorded India's highest growth in international tourist arrivals at almost 27 percent over the previous year, and an average international traveler stays in the state about 14 days per visit. It is important to learn from the experience of India's only "tourism super brand" state, which has been listed by National Geographic Traveler as one of the fifty destinations for a lifetime.

The state announced a comprehensive Tourism Policy in 1995, after which tourism took off in a major way in Kerala. The state focused on the "Six S" framework of India's National Tourism Policy: (i) *swagat*, or hospitality, including facilitation on arrival and memorable experience; (ii) *soochna*, or information, including marketing and promotion, tour operators, and information dissemination; (iii) *suidha*, or facilities, including accommodation, amenities, hygiene, and conveniences; (iv) *suraksha*, or security, including tourist safety and environment management; (v) *sahyog*, or cooperation, including quality control and assurance; and (vi) *sanrachna*, or infrastructure, including tourism product development, and core and linkage infrastructure.

A recent survey of tourists by CRISIL Infrastructure Advisory Services shows that all tourists rate Kerala as "Very Good" or "Excellent" along the Six Ss of tourism development, and 100 percent wanted to revisit Kerala and recommend it to their relative and friends as a tourist destination.

The key ingredients in Kerala's success have been to build tourism on core and naturally available resources, create a distinct brand image, compete internationally rather than locally, provide strong political support and professional administration of tourism development programmes, and give the private sector space to grow. The state has also invested strategically in core and linkage infrastructure, and has made efforts to build a critical mass of tourism workers through appropriate training and capacity building.



## Policy Options to Improve Sectoral Performance

Going forward in the tourism sector, GoHP might consider the following options that would help realize the potential from the sector.

- The state needs to **activate the HP Tourism Development Board (HPTDB)** that has recently been established under the chairmanship of the Chief Minister as a forum for a more strategic approach to tourism development in the state. The HPTDB could go a long way towards improving inter-departmental coordination. The outcome indicators of the HPTDB should be clearly established, with extensive participation of the non-government entities in this process.
- In partnership with the private sector, HP needs to revamp its **marketing and branding strategy** of promoting itself as an up-market tourist destination. The State Tourism Policy, 2005, has identified a number of thrust areas in eco-tourism, pilgrim tourism, and adventure tourism which hold tremendous promise in HP. The state could be projected as an attractive upscale destination for health tourism (spas, health resorts, recuperative centres) and business (conferences and retreats).
- The state must encourage the **private sector** to develop upscale resorts across HP. GoHP needs to facilitate the development of some high-profile projects by the private sector in each of the thrust areas, to be implemented in a time-bound manner. Foreign and domestic investors could be encouraged to set up high-end health resorts, spas, ski resorts and entertainment parks—preferably as part of international chains. Door-to-door tourist packages that handle all logistics, and better standardization and certification regimes for players in the tourism industry could also help the sector.
- The state could consider **disinvesting select properties of HPTDC**, especially those where the private sector is interested. It is important to work out a strategy for the heavy loss-making properties, including closure/sale/lease to the private sector. Resources from privatization could be utilized to upgrade the facilities at the lesser known destinations which are economically viable. A study to assess the profitability and prospects of HPTDC properties could be undertaken leading to the development of a time bound action plan.
- The **airports** at Bhuntar (Kullu) and Jubbal (Shimla) must be developed on a priority basis to address the issue of air connectivity. Instead of spreading scarce resources thinly on upgradation of various airports/airstrips in HP, the state must focus on improving the landing and other facilities at these two airports, and set up a time-bound implementation plan. This will require creating fiscal resources, but would be a valuable long term investment. A first step towards this would be initiation of feasibility studies to cover technical and financial aspects, and to identify viability and sustainability.







## Promoting the Institutional Environment for Inclusive Growth

Himachal Pradesh has many achievements to its credit: rapid improvements in human development indicators over time, a tradition of openness in government, and relatively low levels of corruption. Yet, the state faces major challenges like overstaffing, politicization of recruitment and transfers, and a slow pace of decentralization. Developing a coherent strategy to address these challenges is an important element in sustaining the state's positive past record in human development. In addition, governance reforms could have particular benefits in terms of assisting the fiscal recovery.

Despite objective indicators that are better than national averages, a recent assessment of user perceptions suggests that public service delivery in HP could be strengthened further. Combining data on access to, reliability of, and satisfaction with public delivery of drinking water, health care, the Public Distribution System (PDS), primary education, and transport services, the survey ranks HP

seventh among sixteen states (Figure 5.1). Though this is a perception survey, it indicates that, in the eyes of HP's residents, much more could be done to improve the quality of public services. Bridging this perception gap could also help garner public support for any political party seeking to win state elections.<sup>64</sup>

### A. Enhancing the Effectiveness of the Civil Services

#### Addressing the Problem of Overstaffing

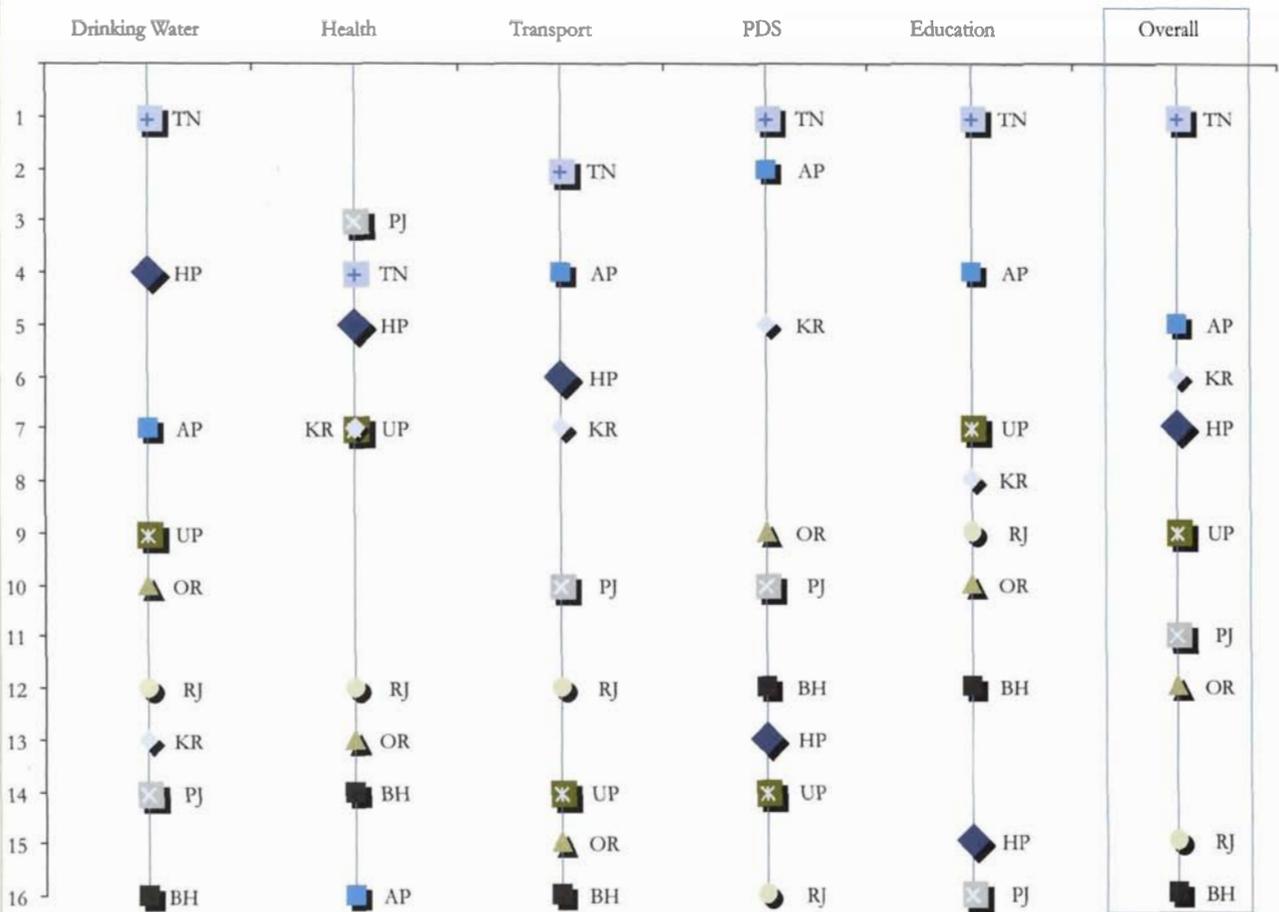
HP has one of highest ratios of civil servants to population in the country, at 4.5 civil servants per 100 of population. It is possible to argue that the large size of HP's civil service reflects the difficulties of effectively serving a small and spread-out population in a region noted for its difficult terrain; yet, it appears more likely that the size of

<sup>64</sup> In any case, surveys based on long-run outcome indicators tend to reflect a state's past achievements far more than any current efforts to strengthen public services.



Figure 5.1: Relative Ranking of Public Service Delivery in Indian States, 2003–04

States are ranked based on perceived quality of delivery, with a lower number indicating a better rank.



Key Perceived Causes of Dissatisfaction with Specific Services in HP

Drinking Water	Health	Transport	PDS	Education
Only 12% and 18% respondents were fully satisfied with adequacy and quality of piped water, and 20% reported access problems and frequent breakdowns in supply.	Almost half respondents reported problems with access to public health care facilities, and only about 10% reported full satisfaction with behavior of doctors and medical staff at facilities.	About 15% respondents were happy with the punctuality of bus services, and 12% and 14% respectively were satisfied with the frequency of the service and the behavior of conductors and drivers on the buses.	Only 6% were satisfied with quality and quantity of grain provided, 11% were satisfied with reliability, and less than half the rural respondents were satisfied with access to PDS supplies.	Only 3–4% of respondents were satisfied with the quality of infrastructure in schools, and access was reportedly an issue for a quarter of rural respondents.

Notes: Based on Samuel Paul, et. al. (2003).



**Table 5.1: Comparative Size of Civil Service in Selected Indian States  
Per 100 of Population**

State	Population	Core Civil Service	Ratio	Total Govt Employees less SOE's	Ratio	Total Public Sector Employment	Ratio
Andhra Pradesh	75,727,541	553,972	0.73	965,892	1.27	1,315,204	1.73
Karnataka	52,733,958	240,969	0.45	530,984	1.00	693,246	1.31
Orissa	36,706,920	480,000	1.30	581,400	1.58	660,928	1.80
Gujarat	50,596,992	206,000	0.40	502,000	0.99	800,000	1.58
Uttar Pradesh	166,052,859	880,000	0.52	1,576,226	0.94	1,730,093	1.04
Punjab	24,289,296	376,222	1.54	431,662	1.77	535,840	2.20
Tamil Nadu	62,110,839	696,700	1.12	1,092,731	1.75	1,317,512	2.12
Rajasthan	56,473,122	529,319	0.93	615,744	1.09	701,362	1.24
Himachal Pradesh	6,200,000	145,556	2.35	235,171	3.79	279,537	4.51

*Notes: Gujarat and Tamil Nadu data pertains to 2002–03 and Rajasthan data pertains to 2003–04. Total Public Sector Employment includes core civil service, work charged and daily wage employees, grant-in-aid institutions, state-owned enterprises and local bodies.*

the civil service is the outgrowth of a strategy designed to offer government employment in a state where other sources of productive employment have been relatively stagnant.<sup>65</sup> It should be noted that education accounts for about a third of government employees.

While the total size of the civil services (excluding PSEs and local bodies) has grown about 30 percent between 1990 and 2003, *work-charged employees* have grown 613 percent while *part-time employees* have grown some 212 percent (Figure 5.2)! Three organizations are particularly bloated in size. The PWD accounts for 29,240 regular staff involved in execution of works and 5,375 regular staff constituting the permanent establishment of the department, in addition to 18,098 daily-wagers. The IPH currently has 3,823 employees in its permanent establishment and 22,444 work-charged employees on

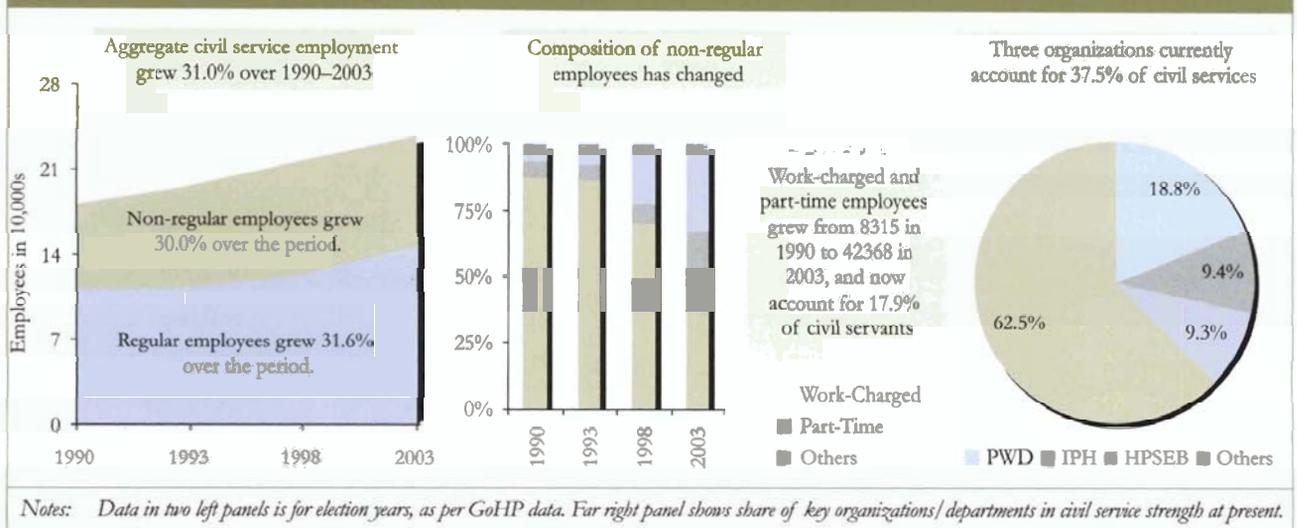
its rolls. HPSEB currently has some 26,100 employees on its rolls, amounting to 59 percent of staff engaged by PSEs in the state.

Analysis suggests that the growing fiscal burden from overstaffing has largely been the result of: (i) *periodic regularization drives*, where regularized employees had to be paid as per standard pay scales, while new hiring of non-regular staff to replace those regularized added to the government's fiscal load and created a new pool of employees who would inevitably be regularized, in due course; (ii) the historic *linking of HP's civil service pay-scales to those of Punjab*, which paid its civil servants more than GoI and other states, such as Haryana. Regardless of the reasons behind HP's burgeoning civil service, the fact remains that the state can no longer afford the resulting wage and pension bill, amounting to 50 percent of the state's revenue

<sup>65</sup> Another hill state with a similar ratio—Nagaland—has serious insurgency problems and lack of non-government employment opportunities, making government the employer of first resort in the troubled state. In order to clinch this issue, one would need data on the ratio of field staff in urban districts, such as Mandi, Kullu, and Shimla, to more remote districts, such as Lahaul & Spiti, but such data was not available at the time of writing this Report.



Figure 5.2: Patterns and Overstaffing in HP's Civil Services



Box 5.1: Wage and Hiring Restraint to Control the Size of the Civil Service Wage Bill

Targeted retrenchment in India has failed as a tool to reduce the size of the civil service. Some states, such as Orissa and Karnataka, and GoI have offered civil servants voluntary retirement packages but there have been few takers. Goa is the only state that has actually succeeded in retrenching the civil service. Some 2,000 civil servants in Goa (five percent of the civil service) have taken advantage of an early retirement programme. The majority was over 55 years in age and about 40–45 percent has been replaced by younger employees. Such a scheme is likely to generate only very limited fiscal savings. In effect, states can only control the size of the civil service through attrition and this necessarily involves enforcing hiring and wage restraint to be effective. AP's core civil service, for example, is estimated to have declined by an annual average of 2–4 percent between 2002 and 2005 as a result of such restraint. As a percentage of GSDP, salaries in AP are estimated to have fallen from 5.5 percent in 2000–01 to 5 percent in 2002–03, and are expected to fall further to 4 percent in 2006–07. If HP can enforce a policy of zero net hiring and limit salary increases to the rate of inflation, then the fiscal costs of a large civil service can be contained successfully.

receipts, thus crowding out much needed capital and non-wage O&M expenditures. Trimming the size of the civil service is thus a key challenge for the state, and experiences from other states could be a useful guide. (Box 5.1).

In order to restrain the growth of the civil service, GoHP could consider taking the following multi-pronged approach.

- Enforce a **strict ban** on the hiring of non-regular staff, especially work-charged and

part-time workers in IPH, PWD, and HPSEB, and curb regularizations.<sup>66</sup>

- Develop a **human resource database** to track all GoHP employees more systematically, audit muster rolls, and weed out ghost-workers.
- Identify **redundant posts** by conducting functional reviews in major departments: (i) assessing whether current staffing patterns exceed established norms; (ii) revise existing norms to take into account technological

<sup>66</sup> In 2005–06 alone, some 22,597 work-charged posts were regularized in PWD and 16,127 in IPH.



improvements and revise staffing norms accordingly; and (iii) identify posts that could be outsourced to the private sector.

- Identify **vacant posts** across government and abolish all posts that are both vacant and surplus.
- Develop an **outsourcing policy** for government and allow outsourcing in several areas, such as the provision of security, gardening, cleaning, and driving.
- Examine avenues for **redeployment** by: (i) creating a surplus pool in government; (ii) training surplus staff for redeployment in other departments or employment in the private sector; and (iii) amending cadre rules to allow greater flexibility in redeployment across cadres.
- Implement a **Voluntary Retirement Scheme** for government employees who wish to leave government service, especially in PSEs, and enforce compulsory retirement provisions in the All India Service Rules to remove inefficient staff from service.
- Accelerate the process of hiring **contract staff**—in education and health—under the supervision of Panchayati Raj Institutions (PRIs) to reduce the fiscal burden on the state.

It will also be important to take measures to decouple pay-scales in HP from those of Punjab, given the fact that Punjab has historically paid its civil servants more than GoI. Pay increases routinely approved in Punjab are automatically translated into pay increases for GoHP civil servants. The issue of decoupling HP's pay-scales from Punjab is a sensitive issue, but a start in the right direction could be made by creating an HP Pay Commission that would, over time, chart an independent course for determining the state's salary structure.

## Rationalizing Government

The state needs to look at measures for administrative rationalization to facilitate effective policy-making and coordination in a complex bureaucracy, and improving the working of the secretariat.

First, there is an issue of **irrational clustering of responsibilities**. GoHP has 11 Ministers, 25 Principal Secretaries and Secretaries, and 45 departments. This is relatively a small number of Ministers, but large number of departments offers an opportunity to cluster departments along functional lines. While some portfolios have been rationally assigned—for example, one Minister handles Revenue, Rural Development, and Panchayati Raj, all linked in one way or another to rural questions—other portfolios do not seem to have been assigned with a view to encouraging functional specialization or linkage.<sup>67</sup> This jumble of responsibilities is repeated at the level of Secretaries: one Principal Secretary, for example, handles both Revenue and Public Works; another handles Horticulture, Environment, Hydropower, and Biotechnology; another handles Information Technology and Labor. This confusion of responsibilities also occurs lower down the bureaucratic hierarchy. Reporting relationships also become more complex with some Secretaries reporting to several Ministers at one time. Accordingly, the state could consider clustering related departments at the level of Ministers as well as Secretaries to provide for greater coordination and linkage across related areas, more efficiency in policy-making, and clearer reporting relationships.

Second, secretariat reform in the area of **file movement** is an important priority. While GoHP has introduced a computerized file monitoring system in 2004, very few Secretaries and their officers are actually using the system

<sup>67</sup> For example, one Minister handles both Animal Husbandry and Housing, two departments which bear little relation to one another. Another handles Excise and Taxation as well as Town and Country Planning, while the Power Minister is also responsible for Pollution Control, which clearly raises conflict-of-interest issues.



to reduce delays and cut pendency. Section officers in particular are not well trained in the use of computers. The use of the single-file system across government is limited, with only Rural Development and Panchayati Raj making use of that at present. GoHP could focus on the use of change management tools to better equip staff for the wider use of e-governance in the Secretariat. GoHP could consider extending the use of the single-file system across government.

### Curbing Irregular Recruitment and Improving Stability of Tenure for Civil Servants

Given the intense pressures on government to recruit, it is not surprising that the process of transfers and recruitment appear to have become politicized, and irregular recruitment in PSEs and other avenues of government employment has become an issue. This also affects the tenure of civil servants in their current positions. While GoHP has taken steps to improve the recruitment process—the Subordinate Selection Services Board, for example, can no longer destroy records after three months, as was the practice in the past, and the Board is beginning to use Information Technology (IT) to enhance the transparency of its functioning—it will be important to follow procedures to curb irregular recruitment. In the small state, it is relatively easy for constituents to contact their representatives to push their case for transfers. The imposition of a ban on transfers (lifted during the transfer season) has had a paradoxical effect: transfers are routinely routed through the Chief Minister's office, thus undermining the authority of Secretaries and HoDs formally vested with the authority to transfer staff. At the mass level, politically-motivated transfers

can lead to skill mismatches, shortages of key staff in schools and PHCs, and fuel the growth of corruption in the state. While data on 'mass' transfers was hard to come by, estimates indicate that some 14 percent of all Health Department staff were transferred in the last year; Karnataka, in contrast, imposed a quantitative limit of five percent on transfers across the board. There is no evidence to indicate that the three-year minimum tenures established by HP's transfer policy for most posts are being followed.<sup>68</sup> Nor are tenures for senior Indian Administrative Service (IAS) officers sufficiently stable to promote effective stewardship of a department's reform programme. The average tenure (in their current posts) of Principal Secretaries and Secretaries in HP is currently a mere 14 months; tenures for Deputy Commissioners are marginally better, at 17 months, but still well below the three-year minimum tenure set by HP's transfer policy.<sup>69</sup>

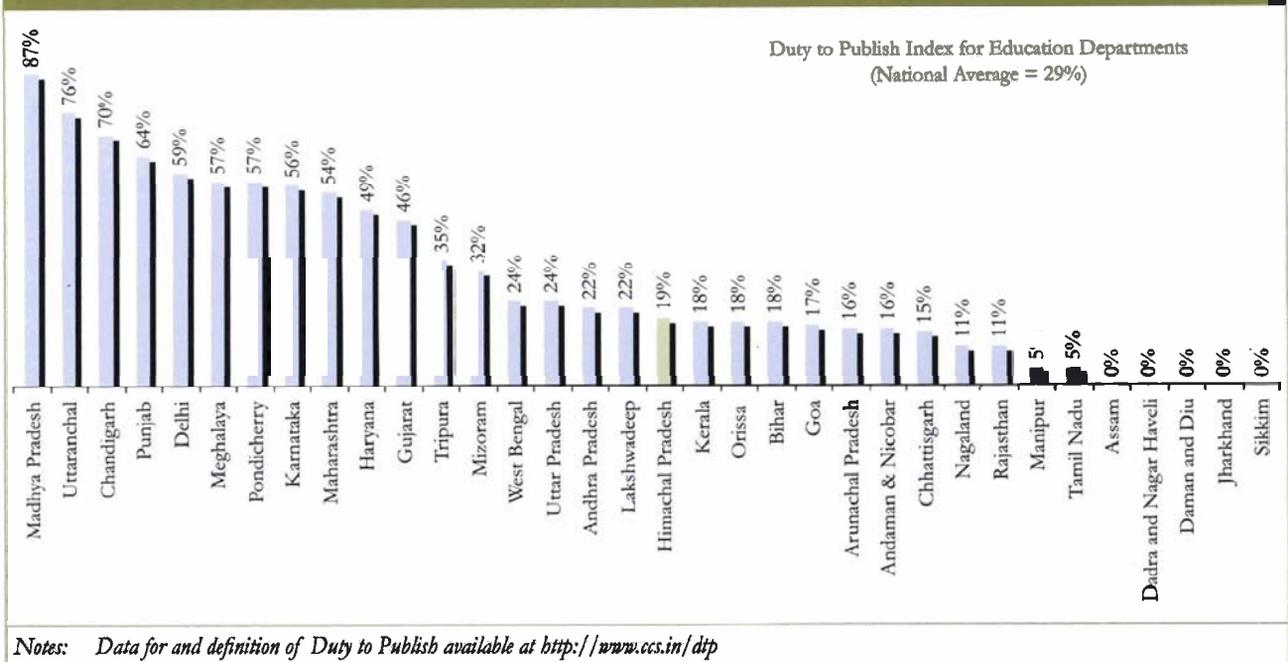
GoHP can improve tenurial stability for IAS officers by creating statutory committees to authorize transfers and postings for senior officers, including exceptions to the three-year minimum tenure on the basis of clearly defined reasons. Transfers of senior IAS officers should be closely monitored through the creation of a stability index to ensure that the average tenure of the IAS cadre as a whole in the state does not fall below three years. These steps will also help prepare GoHP for the implementation of new All-India Service Rules establishing minimum legal tenures for senior officers. At the level of general transfers in staff-intensive departments, GoHP could consider the adoption of a system of formal counseling to allocate transfers and postings in a rational and objective fashion, while enforcing quantitative limits on the total number of transfers across the state (e.g., limiting aggregate transfers to only five percent of civil service size).

<sup>68</sup> Employees often want transfers for a variety of reasons: some wish to be posted to their home districts; others want to move from a rural district to an urban centre; and still others want postings to 'coveted' positions offering opportunities for rent-seeking, particularly in departments that deal with taxation or public works (e.g., PWD and IPH).

<sup>69</sup> A senior IAS officer in HP is likely to enjoy about the same truncated tenure as one in Punjab or Jharkhand.



Figure 5.3: Low Compliance under RTI, 2005



## B. Strengthening Institutions for Transparency and Accountability

It is important to note that, while HP residents do not rank in the state's services near the top relative to other states, they do not appear to view corruption as a major problem (Figure 5.4). HP is one of the few states in India to have enacted legislation to address corruption in public service delivery providing jail terms and fines for officials and non-officials for a series of offenses such as corruption in the award and execution of contracts, including contract splitting; manipulating muster rolls or measurement books; supplying sub-standard goods to government; adulterating medicines or manipulating their purchase; charging illegal fees; lending to fictitious persons; maintaining false records; and absenting oneself from public duty.<sup>70</sup> However, it

is important to maintain this impressive performance in restraining corruption, and further strengthen institutions of public accountability.

The **Right to Information (RTI)** Act needs to be aggressively implemented. It has been in force for almost a year, but usage of the Act has been low and the State Information Commission has received only 15 appeals since the Act came into effect, which is far lower than the appeals received in Karnataka, for example. All government departments are now required to release a large cache of information to the public, in order to reduce the need for explicit requisitions. A recent study of Education Department websites in 27 states and 7 Union Territories along 37 dimensions ranked states on a "Duty to Publish" index, where HP was ranked only eighteenth (Figure 5.3).<sup>71</sup> Though several other states also perform poorly in their publication requirements

<sup>70</sup> See The Himachal Pradesh Prevention of Specific Corrupt Practices Act, 1983 for more on this.

<sup>71</sup> See 2006 Report Card on RTI Compliance by State, conducted by the Centre for Civil Society, New Delhi, which constructs a 37-point index based on Section 4 of the RTI, for the Education Departments.



under the RTI, HP is ranked below national averages in this regard, and is far behind other hill states like Uttaranchal. This suggests that there is considerable room to improve compliance.

Low usage may reflect HP's tradition of openness in government, resulting in more information being available in the public domain in the first place, as well as the lack of strong NGOs capable of demanding the release of sensitive information from the government. There are several ways to expand access to information in the state. First, GoHP should *strictly implement* the *suo-motu* provisions of the RTI Act releasing proactive information relating to development works, to facilitate social audits by local institutions, for example. Second, departments should be *required to post suo-motu information on their websites*; departments that still lack websites should be encouraged to create them as fast as possible. Third, GoHP could consider funding the *training* of officials and citizens in the use of the Act. Fourth, the Act itself needs to be *publicized* across the state to encourage citizens' to use its provisions to bolster accountability.

**Accountability institutions** could be made more effective. HP does have an independent *Ombudsman* (Lok Ayukta) in place, with the power to investigate allegations of corruption relating to public servants (including politicians and ministers)—although there are avenues to strengthen this institution through increasing capacity and powers.<sup>72</sup> The state could consider amending the Lok Ayukta Act to allow him *suo-motu* powers allowing him to take action in cases without a formal complaint, by providing qualified legal and other staff to assist him, and by widening the definition of corruption to include grievances arising out of maladministration, as in the case of the Karnataka Lok Ayukta

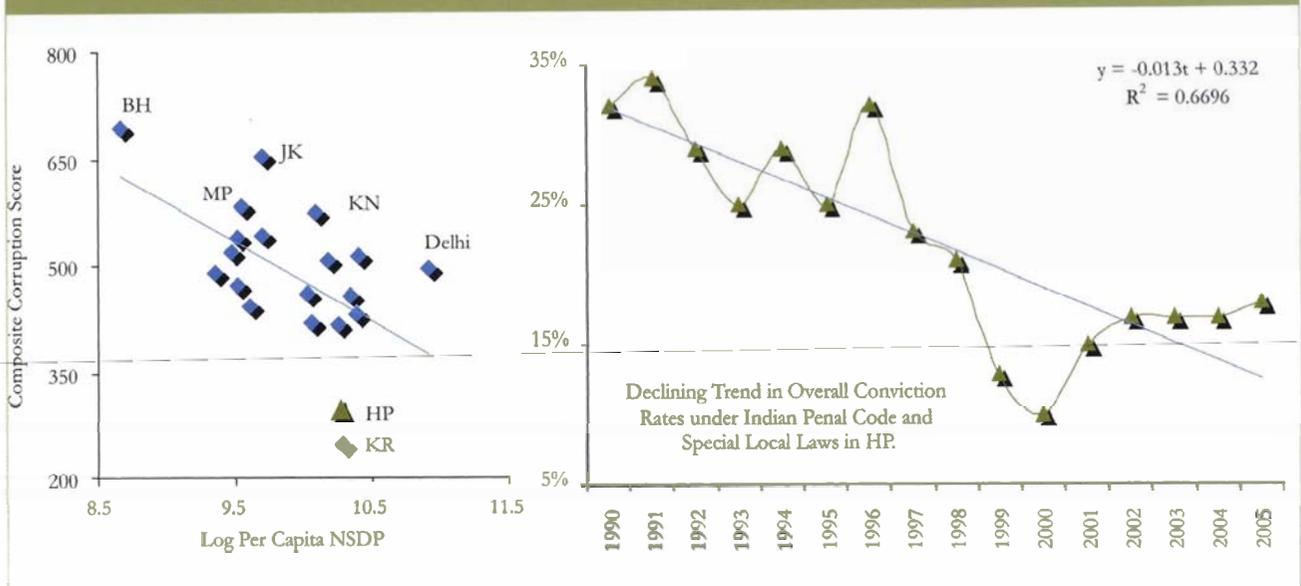
**Vigilance mechanisms** in the state—which are showing some signs of weakening—have to be strengthened. The *Vigilance Department* has a high rate of pendency—approximately 491 complaints are pending, preliminary inquiry and 33 regular inquiry, while some 115 cases remain in Court without a resolution. The state could consider processes to strengthen the Department by streamlining departmental inquiries with strict deadlines for investigating a case and laying down penalties within a finite period of time, say six months. More troubling is the fact that the *overall conviction rate* for all crimes (including, but not limited to, corruption cases) under the Indian Penal Code (IPC) and Special Local Laws (SLL) has fallen (Figure 5.4). The trend towards lower conviction rates over time reflects political interference in investigations, vacancies in key positions in the police force, loss of organizational morale, and weaknesses in capacity to investigate and prosecute crime—and does not bode well for the security of HP residents over the longer term or the state's capacity to combat crime effectively. Measures to reverse the weakening of police capacity to provide effective law and order services, reflected in the declining overall conviction rate, could include: (i) implementing the recent Supreme Court directive to create a State Security Commission to insulate the force from political pressures; and (ii) enforcing a minimum tenure of three years for the Director General of Police (DGP) and senior officers.

**E-governance** is a powerful tool for improving the efficiency and transparency of public service delivery. It has enormous potential in HP as a tool for simplifying transactions and making it easier for citizens to access government services. There are several examples of successful initiatives in this area which HP could draw upon (Box 5.2).

<sup>72</sup> The Lok Ayukta has the power to: (i) investigate allegations of corruption relating to public servants; (ii) seize documents and evidence in inquiries, summon officials for public hearings; and (iii) hold officials in contempt for not cooperating with him. The Lok Ayukta is headed by a judge of the rank of a Supreme Court justice or Chief Justice of the High Court. GoHP has traditionally cooperated with Lok Ayukta investigations, and taken action on Lok Ayukta recommendations in most cases on a timely basis.



Figure 5.4: Low Corruption but Declining Conviction Rates in HP



Notes: Left panel y-axis shows corruption scores from the Transparency International India Corruption Study (2005) for selected Indian states, with a lower number indicating lower corruption. HP's corruption score is lower than predicted by income in the Indian context. Right panel shows trends in conviction rates in HP, as per data obtained from GoHP, with a linear time trend fitted.

### Box 5.2: E-Governance Initiatives in Other States

E-Governance, combined with business process re-engineering, has played a vital role in improving the quality of service delivery across agencies and reducing opportunities for corruption. The introduction of computerized land records in Karnataka, for example, has cut the weighted average of bribes paid from Rs. 152 per person under the manual system to a negligible Rs. 3 under the new one, according to a survey by the Public Affairs Center, Bangalore. The application of e-governance, along with major business process changes, such as banning the use of stamp paper, placing guideline values on the internet, creating model deeds for public use, and setting up a central valuation committee has vastly improved the functioning of the Registration Department in Maharashtra, while curbing corruption, according to a recent study commissioned by the World Bank. One-stop service centers, such as E-Sewa in AP, have helped reduce the difficulties associated with bill payments and opportunities for rent-seeking by allowing the public to effect multiple transactions under a single roof controlled by a private operator, instead of visiting departmental offices. The creation of a centralized complaints database accessed through a complaint cell located in Headquarters, as well as by email and telephone, has armed senior officers of the Hyderabad Water and Sewerage Board with the necessary information to hold junior officers and front-line staff more accountable to the public. Computerized file monitoring in the Karnataka Secretariat has cut file pendency, made it easier to locate a file on its journey upwards and downwards, and reduced opportunities for rent-seeking.

Experience from other states shows that e-governance solutions work best when a mix of factors prevail, particularly tenurial stability for administrators supervising the project, line department ownership, and high-level political support. A public-private partnership model usually works better than an in-house efforts by bridging gaps in technical capacity and funding as well as injecting new management skills that might not be readily available in government. User fees retained by providers are normally necessary to ensure the long-run sustainability of such initiatives. Bridging departmental silos is a key element in agency reforms. E-Sewa, for example, brought together several departments on common platform. In the urban sector, umbrella groups like the Bangalore Agenda Task Force made it easier for stakeholders and agency reformers to coordinate reform processes in the city with the full support of the Chief Minister



HP has made significant progress in this area, though some challenges remain which GoHP could address.

- First, the IT Department lacks **technical capacity** to drive the vast gamut of projects currently underway. It is short of technical staff, and could benefit from the authority to contract from the private sector at competitive rates. The Department has witnessed considerable tenurial instability at the Director level, resulting in a weakening of capacity. The capacity of the IT Department needs strengthening, and GoHP should ensure that it has the last word on issues relating to the definition of inter-operability standards, the use of particular software packages across government, and the right to monitor the quality and progress of initiatives undertaken by departments.
- Second, **priorities** could be clarified further for the IT Department. There are currently 40-odd e-governance projects underway in the state, and these could be sequenced based on departmental capacity and need. Projects that could constitute the backbone of a powerful e-governance push for the state could include the development of a state wide area network, the development of Integrated Citizen Services Kiosks, the computerization of land records together with property registration, and the application of information technology to local government functions and augment its capacity to implement projects.
- Third, there is a need to build **departmental ownership**, as the IT Department is not in a position to drive from the outside e-governance projects that belong in particular departments. While departmental capacity for IT has been augmented by the appointment of nodal officers under the Project E-Mission Team (PEMT) initiative, these officers are too junior to drive

projects, and can only monitor them and offer technical solutions as necessary. Projects need to be driven by senior officials with the support from the Secretary, and adequate political backing.

- Fourth, e-governance cannot succeed without **process re-engineering** where necessary. Computerizing existing processes without simplifying or restructuring them yields few benefits for either the government or citizens.<sup>73</sup> The focus should be on process re-engineering, rather than just information technology.
- Fifth, **Public Private Partnerships** (PPPs) are lacking in this area, largely because private players are reluctant to invest as they see low volumes in IT initiatives given the state's low population density, although this logic clearly does not hold true for the state's major urban centers at present. Wherever possible, PPPs should be the preferred mode of implementing projects, as it is a useful way of mobilizing additional financial resources for a project, as well as new technical and managerial skills. Private parties can also be held to account more easily than public sector actors through Service-level Agreements (SLAs).

## C. Promoting Decentralization to Improve Local Provision of Services

GoHP is committed to the process of decentralization. The latest Budget speech stresses the importance of strengthening local-level accountability mechanisms by enhancing PRI control over staff, such as teachers and para-medics, as well as strengthening PRI capacity. It is likely that decentralization will help improve the quality of service provision in HP, through better

<sup>73</sup> Computerizing land records without verifying their accuracy, suppressing the use of manual records, or effecting links to property registration is not likely to yield major benefits in the long-run; nor will the computerization of the Registration Department in the absence of additional steps, such as the abolition of the use of stamp paper, the creation of a central valuation committee to hold district valuation committees accountable for their decisions, and possibly lower registration rates.



### Box 5.3: Community Participation in Hospital Management

MP's Rogi Kalyan Samiti (RKS) represents a creative adaptation to the problem of excessive spending on salaries. Under RKS, district hospitals are turned over to the independent societies, which not only manage hospitals, but have the power to levy user fees, solicit private donations, use vacant hospital land to generate more revenue, and outsource cleaning and other functions. RKS societies consist of important players locally including the collector, MLAs, and NGOs. User fees collected by RKS societies are directed towards funding maintenance and the cost of purchasing new equipment for the state's often dilapidated hospitals. The first RKS society was introduced in Indore by the collector in 1995 to sustain improvements after the massive clean-up of the city's Maharaj Yeshwant Rao Hospital launched in the wake of the outbreak of plague in nearby Surat in 1994. MP's Chief Minister was so impressed with the results that he decided to roll-out RKS to all health facilities in the state ranging from district hospitals to community health centers to primary health centers at one stroke. The RKS model is popular with doctors and staff because it makes available the equipment that might not otherwise be affordable given the high proportion of the budget spent on salaries. By earmarking user fees for maintenance and equipment, RKS societies helped improve the productivity of salary expenditures by topping them off with necessary non-salary spending. The poor are exempted from paying user fees on the basis of self-identification, rather than any formal criteria. The central government's National Health Mission has recently identified the RKS model for replication across the country.

RKSs were introduced in HP in June 2001. Prior to the constitution of RKSs, user charges were deposited in the treasury. But with the constitution of RKSs, not only were the RKSs free to set their own charges but the amount so collected was put at their disposal. RKSs had a representation from both government and the civil society. However, in 2003, the RKS was reconstituted as the Aspatal Kalyan Committee, which had only officials as its members. Following recent ruling by the High Court, it is expected that the RKS will be revived. In order to develop successful RKSs, the key ingredients would be: (i) civil society representation in the Samities; (ii) reasonable user charges if decided by the state government, or by the Samities as per the guidelines of the state government; (iii) autonomy to Samities with respect to use of the amount collected by way of these charges; and (iv) exemption of the poor from these charges, with this power be vested with the RKS.

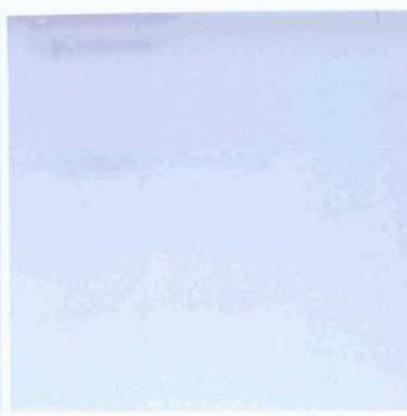
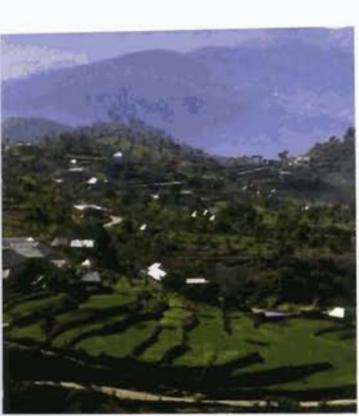
community participation, as it has in other states (Box 5.3). Despite the government's stated commitment to decentralization, however, progress in this area has been relatively slow.

Activating local government control over local providers is likely to result in improved performance and spark more pressure on government to fill vacancies in schools

and PHCs in remote areas. Strengthening PRIs can also help improve the capacity to monitor the execution of programmes and schemes at the local-level. These are issues—along with improving revenue mobilization at the local level—that deserve serious policy attention as HP seeks to move towards second-generation reforms that focus less on access to public services and much more on their quality.

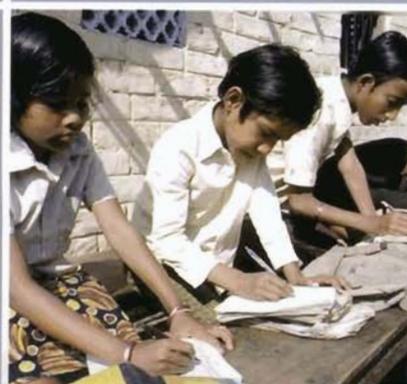
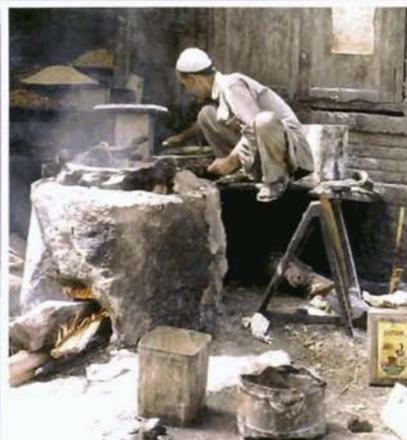






06

## Strengthening Human Development and Social Protection Strategies





## Strengthening Human Development and Social Protection Strategies

Himachal Pradesh has made impressive strides in poverty reduction and human development, and has achieved indicators that many other states in India aspire to. Accordingly, HP faces what may be termed “second generation” challenges in this area. The state does not perceive major problems in terms of basic access to services—which is a common concern in lagging states of India. The issues in human development are mainly around quality improvements, and building partnerships with private parties and communities to enhance efficiency and ease the fiscal burden. In the area of social protection, the state faces a dual set of challenges as it seeks to improve the system: (i) continuing to improve administration of existing safety net programmes; and (ii) exploring and experimenting with new areas of social protection which will be increasingly demanded by a wealthier population facing the challenges of economic and social liberalization.

The human development sectors assume direct relevance in view of the stated goal of **inclusive development**—particularly for remote areas and disadvantaged segments of the population. This chapter looks at

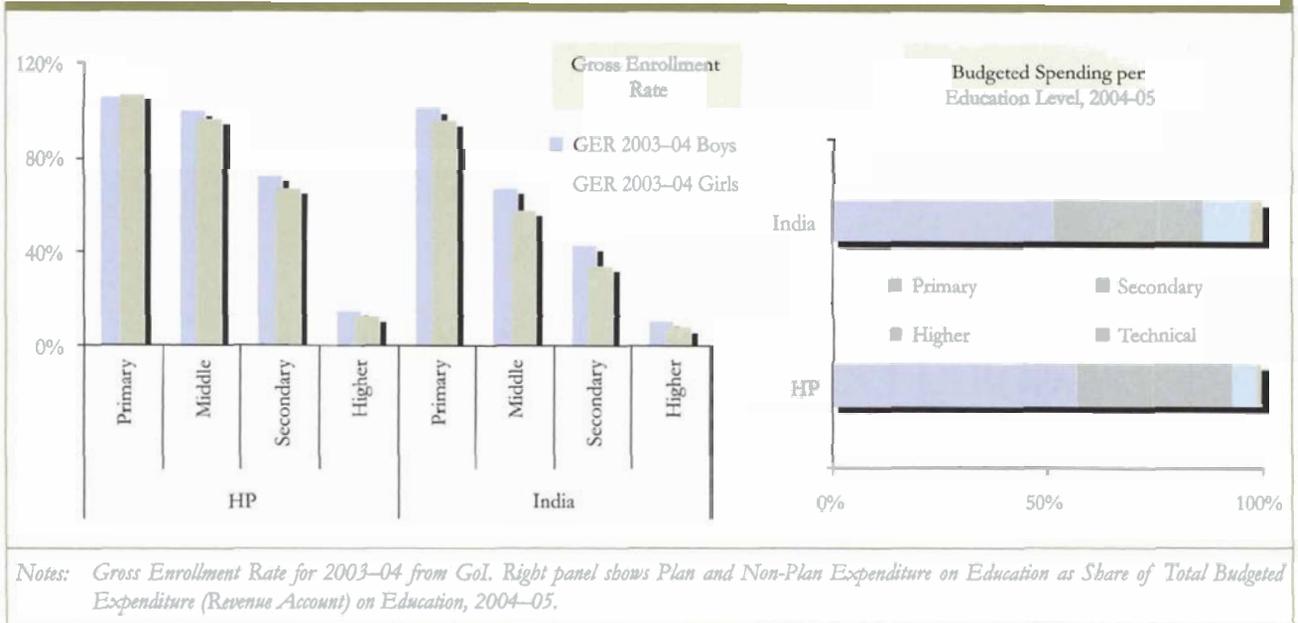
policy options arising from an analysis of challenges in the social sectors.

### A. Education

HP has been strongly committed to education, and has made impressive progress in the sector. According to the 2001 Census, the literacy rate in HP was 76.5 percent, which was nearly 12 points higher than the national average of 64.8 percent. There is universal access to primary schooling in the state. Enrollments are high even in post-primary levels of schooling, with near gender parity. The state does better than national averages at all levels of enrollment (Figure 6.1). Although there are gender differentials, these are lower than national gender gaps, and show up more at higher levels (Figure 6.1). Public expenditure on education in HP is relatively high, with one of the highest per pupil expenditures on education among the major states of India. However, HP spends more of its education budget on primary and secondary education than the average Indian state (Figure 6.1).



Figure 6.1: Educational Outcomes and Spending in HP Compared to National Averages.



In this sector, the state faces challenges around improving the quality of education, rather than access. There are issues around provider absenteeism and training, and some aspects of school infrastructure could be improved. In view of the skills mismatch in the state described earlier, it is also important to reorient the sector to provide education that can enhance employability. Finally, as in other walks of life in HP, innovative PPPs can promote efficiency of education services, and release state resources for other investments.

### Quality of Education

While learning outcomes in the state is much better than the average Indian state, the state still has some way to go to achieve good quality education. In the lower age-groups, for example, a 2005-06 survey finds that 19.5 percent of students in the age-group 6-14 years cannot read a small paragraph of short sentences of

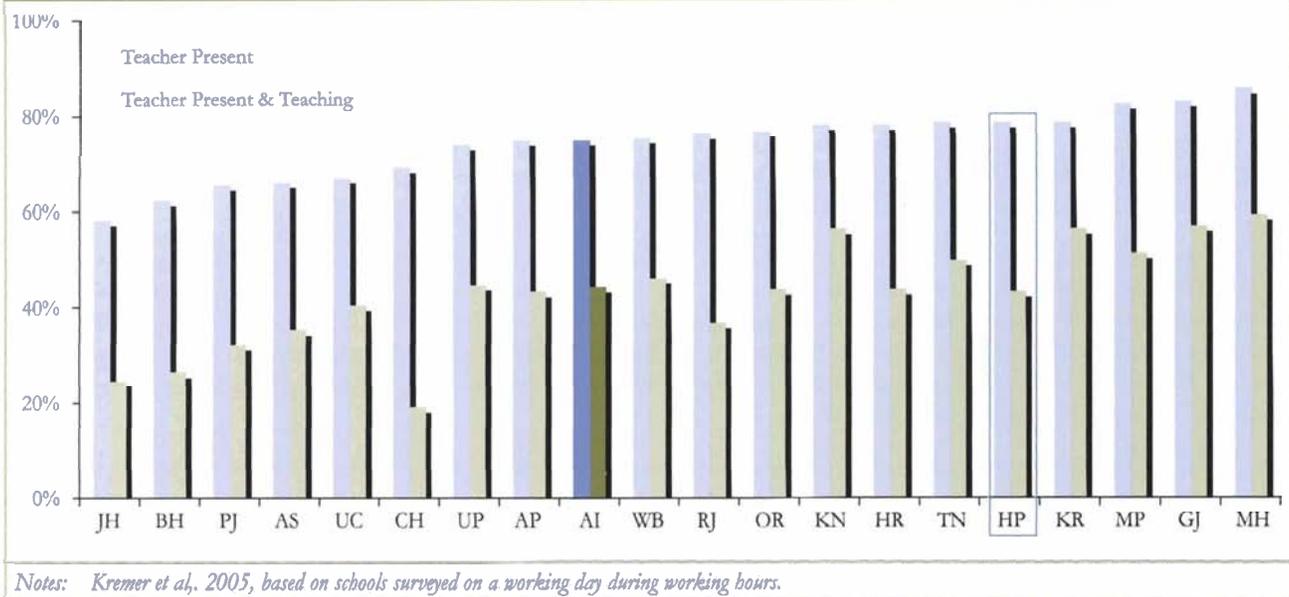
Grade 1 difficulty, and 36.6 percent of the same age-group cannot read a story text with some long sentences of Grade 2 difficulty.<sup>74</sup> In mathematics, 22 percent of the age-group cannot solve written numerical sums that require two digit subtractions with borrowing, and 44.9 percent cannot divide three digits by one digit. Quality of secondary education in the state is also a cause for concern. Evidence of this comes from the pass rates of students sitting for secondary and higher secondary final examinations. In 2002, pass rates were only 46 percent and 40 percent among students who took the secondary and higher secondary examinations respectively. Student preparedness in lower grades is particularly poor, and this, in all likelihood, affects overall learning achievements.

The quality of education in basic schooling needs to be improved. This requires paying more attention to student learning in the lower grades, in particular. In order to improve quality of education, GoHP could look at two dimensions.

<sup>74</sup> Annual Status of Education Report, 2006, PRATHAM.



Figure 6.2: Teacher Absenteeism in HP and Other States



### Improving Teacher Training

An aspect that plausibly contributes to low learning levels in lower grades is the quantity and quality of teacher training. Education experts make the distinction between pre-service and in-service training, considering the latter to be more effective in having an impact on learning outcomes. In HP, about 98 percent of all regular government school teachers and 81.1 percent of para-teachers had basic qualifications in 2005. However, 71.7 percent teachers in primary schools and 56.9 percent of teachers in upper primary schools received any in-service training in the previous year.<sup>75</sup> Accordingly, it is important for the state to complete relevant in-service training, especially of teachers in primary grades.

### Curbing Teacher Absenteeism

Teacher absence is relatively high in the state. A recent survey, in fact, finds it to be only marginally lower than

national averages, and only about half the teachers present were actually found to be involved in teaching—which is a disturbing finding (Figure 6.2).

The state needs to consider measures to curb teacher absenteeism through a mixture of monitoring and incentive mechanisms (Box 6.1). Enhancing decentralization could be particularly valuable in this context. GoHP should consider vesting PRIs with the power to hire and remove all new teachers, as well as halt salary disbursements for teachers who fail to teach, as a first step towards strengthening the quality of public services at the local level.

### Partnership with the Private Sector

Partnership with the private sector can improve quality as well as free up fiscal resources. The government is the key provider of education, especially at lower

<sup>75</sup> Elementary Education State Report Cards, 2005, NIEPA.



### Box 6.1: Measures to Curb Teacher Absenteeism in Other States

Various interventions, especially experimental, have been put into place to improve attendance of teachers in schools. GoHP could pilot similar measures to improve teacher attendance.

In some schools in Rajasthan, teachers were given a date and time tamper proof camera and modest monetary incentives to provide pictures of themselves and children at opening and closing times of each school day. This experiment in impersonal monitoring reduced absence rates by half and increased the number of teachers with high attendance records in treatment schools vis-à-vis comparison schools (Duflo and Hanna, 2005).

Experimental evaluations are underway in a few states in India whereby teacher attendance is expected to improve through greater beneficiary control over service providers via an education information campaign in treatment villages vis-à-vis no campaign in control villages (Pandey, forthcoming). Even though local communities and parents through the PRIs and other local bodies such as Village Education Committees (VEC) and Parent Teacher Associations (PTA) have control over school functioning in principle, in practice such control is either weak and ineffectual or non-existent due also to lack of any information regarding entitlements and controls.

Non-experimental initiatives are also being implemented in some Indian states. For example, Orissa is considering a career path for contract teachers similar to the tenure track system in US universities. The basis for teachers' promotion will be their performance evaluation along a number of dimensions, including attendance and students' learning achievement. The state has also authorized the VECs to certify teachers' attendance for their salary release.

levels. In 2005, 91.1 percent (compared to the all-India average of 75.1 percent) of children in the age-group 6–14 years in the rural areas of HP went to government schools, and only 7.1 percent (compared to the all-India average of 16.4 percent) went to private schools. The state realizes the importance of the private sector in providing higher and technical education in particular, and is taking steps to partner with private parties. For example, the Private Universities Act was passed in 2006 to allow establishment and regulation of higher education institutions in the private sector. GoHP is looking for private sector partners who can use the state's existing educational facilities to conduct technical and vocational courses that can improve employability of the youth—with the private party to guarantee some minimum percentage of placements for students who take the offered courses. Such innovative measures can reduce the burden on the government, and help improve marketability and employability of educated youth.

## Basic Infrastructure

The state has done well in developing some dimensions of school infrastructure, but lags along other dimensions. Except for the thinly populated districts of Kinnaur, Lahaul & Spiti, all other districts in HP have attained the norm of a primary school located within a kilometer of a habitation. About 86.4 percent of all schools have a drinking water facility, and 5.2 percent of primary schools and 11.7 percent of upper primary schools are single classroom schools. At the same time, in a recent survey, only 3 percent of people surveyed in the state expressed satisfaction with the quality of toilets in government primary schools.<sup>76</sup> In the same survey, only 4 percent of the respondents expressed satisfaction with the quality of school buildings. About 35 percent schools in the state have a common toilet and only 23 percent have a girls' toilet.<sup>77</sup> Only 55 percent of primary school

<sup>76</sup> See Paul, et al. (2006).

<sup>77</sup> Elementary Education, State Report Cards 2005, NIEPA.



and 50 percent of upper primary school classrooms are in good condition. Accordingly, it is important to upgrade infrastructure quality in schools, and this requires fiscal resources.

## B. Health

HP has better health indicators than many other states of India, as discussed above.<sup>78</sup> In HIV/AIDS, which is one of the MDGs, the state falls in the low prevalence category, since HIV prevalence rate is less than five percent in high risk groups and less than one percent among antenatal women. The life expectancy of 65.9 years in HP is higher than the national average of 62.5 years.<sup>79</sup> Public health spending in the state is higher than in most other states of India.

However, there are some areas where the state needs to improve performance. Indicators such as IMR—which has actually risen slightly as per the latest National Family Health Survey figures—and MMR continue to be matters of concern.<sup>80</sup> Furthermore, in the border belts adjoining Punjab and Haryana, the state has experienced adverse sex ratios. The hilly terrain of HP poses special challenges. Diseases specific to the hilly region—such as Chronic Obstructive Pulmonary Disease (COPD), and other unintentional injuries/accidents account for a relatively high share of the burden of disease.

There are policy issues in this sector around the composition of manpower, infrastructure, and access to services for remote districts. Private participation in this sector is low, as in other aspects of service delivery. Accordingly, GoHP could look at the following areas in the health sector.

## Human Resource Planning

A key issue for the Health Department is human resource planning. While there are no major issues at the lower skill end of personnel, there is a shortage of specialists and qualified workers. In September 2006, for example, over 10 percent of doctor's positions were lying vacant. Retaining and posting qualified staff in rural remote areas is also a challenge confronting the state.

There is a need to ensure that adequate number of sufficiently motivated and well-trained staff exists at the facility level. There may actually be a case for filling sanctioned specialist posts that are currently vacant in rural and remote areas, based on analysis of needs and availability. It is also important to provide good training to the existing staff. While it may be difficult to post specialists at lower health facilities, general duty doctors can be imparted training in special skills. For example, GoI has short training modules for doctors in areas such as anesthesia.

## Health Infrastructure

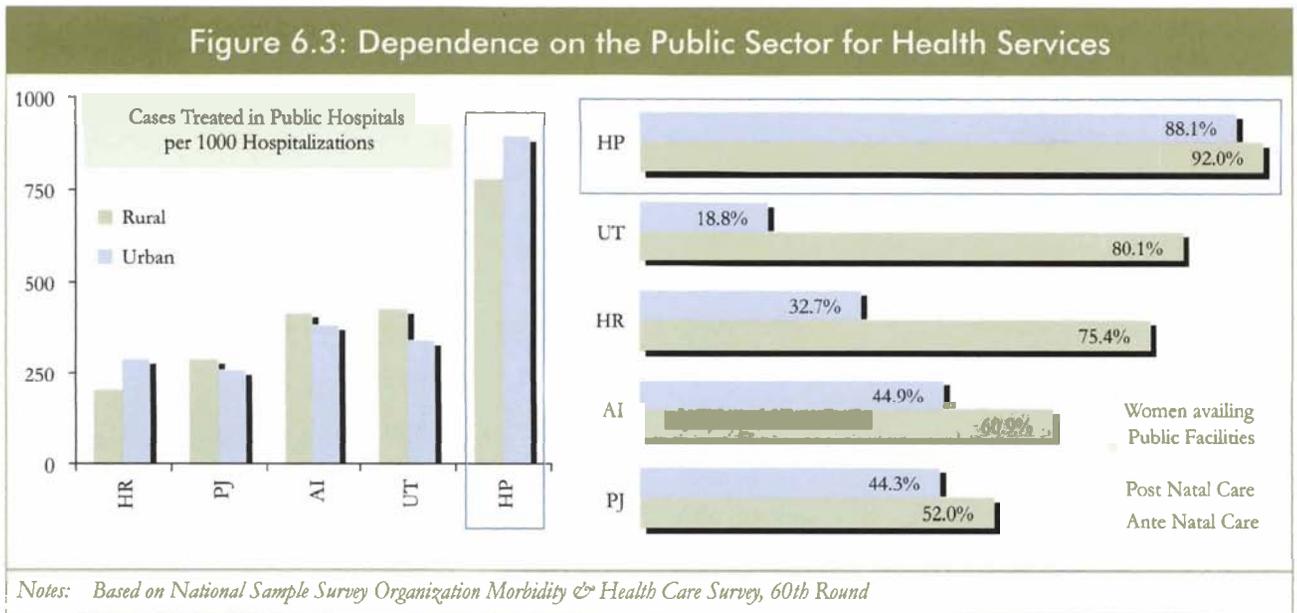
The Health Department perceives infrastructure shortages in the state. PHCs are currently not equipped to handle complicated delivery cases, and the state sees an unmet need for labor rooms at PHCs, along with residential accommodation for trained personnel. There are some 800 PHC and sub-center facilities still to be constructed, currently functioning on rented premises or on space provided by Panchayats/Trusts, making renovations difficult and impacting the quality of care.

<sup>78</sup> See Chapter 1.

<sup>79</sup> Life expectancy figures pertain to the period 1998–2002.

<sup>80</sup> Although IMR in HP is lower than the national average, peri-natal mortality, early neo-natal mortality and still birth rates in HP are almost as high as the national average.





HP is one of the focus states under the National Rural Health Mission (NRHM), which, among other things, provides for upgradation and renovation of public health infrastructure up to Community Health Center (CHC)/First Referral Unit (FRU) level. Although NRHM is evolving, the Health Department perceives some gaps which cannot be funded even under NRHM—like residential accommodations for medical officers and paramedical staff, and medical equipment at PHCs. For construction of the 800 new buildings (for facilities that currently exist on rented/donated premises) that have been identified, the Department is supposed to tap funds from the Rural Development Plans. However, under this, the support for construction of new buildings is available in a phased manner and therefore the civil works cannot be undertaken quickly, and funds available are inadequate as GoI construction norms for the hill regions are no different from that for the plains. Accordingly, the Health Department needs to identify funding gaps in the construction of buildings and purchase/maintenance of equipment at primary level, and develop an action plan to fill them.

Moreover, given the high incidence of road accidents in a hilly region, it is important to have dedicated trauma

centers. Currently, HP does not have any, though casualty services exist in all zonal and district hospitals. HP plans to set up six dedicated trauma centers along the national highway, and GoI has already provided funds for one centre in Kullu. Funding for other centers still needs to be raised.

### Partnership with the Private Sector

Health services are still largely in the public domain, and the government is the key provider of health services—more so than neighboring and similar states (Figure 6.3). Since the last year, the Health Department has been considering PPPs mainly in three areas: (i) contracting out about a dozen sub-centres and half-a-dozen PHCs to private agencies for service delivery; (ii) diagnostic services; and (iii) ambulance services. The regions in which these are to be tried have not been finalized yet. The government is in the process of advertising this fairly quickly, and then seeing this up and running by early next year. Depending on the success of these pilot initiatives, these measures could be scaled up and replicated.



## Special Initiatives to Improve Access in Remote Areas

In a hilly region, accessibility is an important issue. First, the potential for **tele-medicine** seems strong. At present, two tele-medicine centres in the state are functional in Shimla. The Department of IT has promised to support 20 telemedicine centers entailing a cost of Rs. 45.1 million. This project, which is already underway, was to finish by March 2007, but got delayed due to connectivity problems and is now expected to finish by September 2007. This could be a promising measure that GoHP could explore further. Second, the state could experiment with **mobile clinics**. HP is yet to seriously explore their viability in delivering primary healthcare services in place of static healthcare clinics in remote rural areas. These may turn out to be a better option in the interiors where, even if it visits a village 2 to 3 times a week on pre-determined days, it may prove effective. At present only two mobile medical units are functioning in Kinnaur. The feasibility depends on a number of factors such as terrain, road connectivity, case load, and distance to the nearest health facility. Senior officials in GoHP feel that mobile units cannot replace a static facility; they can only supplement services of static units by organizing disease-specific services during health camps, providing diagnostic services, and delivery medicines, etc. GoHP could examine the feasibility and cost-effectiveness of mobile units, in comparison to static units, and consider pilot initiatives that can be studied intensively, and scaled up.

## C. Social Protection

Given the low poverty rate in HP, the relative importance of traditional social protection programmes is lower than many states. However, they assume direct relevance

for the state in view of its stated goal of promoting inclusive development. The sector faces common challenges in improving the basic administration of several programmes under the current set-up. The key medium term strategic issues in social protection relate to second generation needs of the population in the face of expansion into higher value (but higher risk) production, demographic transition, and social problems related to vulnerability and exclusion.

The **spending on anti-poverty programmes** from the state's own resources has been fairly stable at low levels in recent years, at just over 0.5 percent of GSDP. The most distinctive feature of social protection spending in the state is the high share of expenditure on social pensions—for destitute elderly, widows, and disabled—that accounts for almost half of total state spending in recent years, with spending on public works accounting for another 30 percent.

**Programme coverage** in HP is generally good, with a few exceptions. Based on new survey data covering a representative section of households, 92 percent of households are receiving some benefit under at least one of the main government social protection programmes, compared to the all-India average of about three-quarters.<sup>81</sup> The coverage of individual anti-poverty programmes appears to be close to the national average for most programmes, with the notable exception of social pensions where coverage is significantly higher (Table 6.1). The coverage of life insurance and the Kissan card in HP is higher than in the rest of India, but health insurance coverage is very low (Figure 6.4).

**Targeting of programmes** is an area where relatively little is known for the major anti-poverty schemes. Looking at *geographic targeting*, the district-level targeting for the public works and rural credit

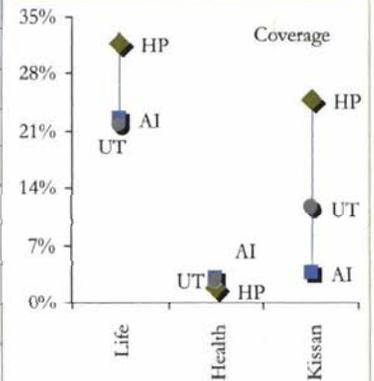
<sup>81</sup> These results are from Ajwad (2006) based on the National Human Development Profile of India, 2004–05, a household survey conducted by NCAER in 2004–05 with World Bank support. The sample size for HP was 1,373 households (representative at the state and rural-urban level), allowing descriptive analysis of most major social protection programmes, with the exception of SGRY.



**Table 6.1: Coverage and Benefit of Selected Programmes**

	Coverage (% of households)				Benefits (Rs.)	
	HP	India	Uttaranchal	Punjab	HP	India
PDS Card	94.6	82.8	90.6	88.6		
IRD/SGSY	2.3	0.9	0.4	0.1	1,376	12,000
Housing	7.6	8.4	13.8	2.4		
Scholarship	5.2	6.3	16.6	1.4	858	1,360
<b>NOAPS</b>	<b>4.4</b>	<b>3.1</b>	<b>1.7</b>	<b>6.2</b>	<b>2,613</b>	<b>2,255</b>
Widow Pension	6.9	1.8	1.7	1.3	2,269	1,976
Disability Pension	1.0	0.4	0.2	0.3	2,271	1,985
NFBS	0.1	0.3	0.2	0.0	1,000	493

**Figure 6.4: Insurance**

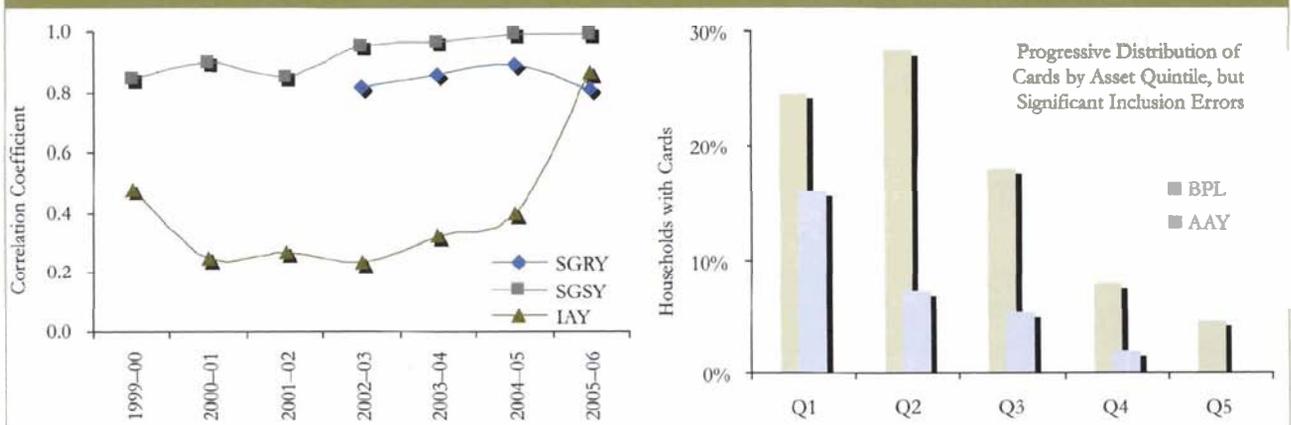


Notes: Bank staff calculations based on NCAER survey, 2004–05. Right panel shows percentage of households with life and health insurance and Kissan cards, in HP compared with All India (AI) and Uttaranchal (UT), which is another hill state.

programmes appears to be progressive, and districts with a higher share of Below Poverty Line (BPL) population get a higher share of expenditure under the programmes (Figure 6.5). However, the rural housing programmes under Indira Awas Yojana (IAY) are far less well-targeted to districts with larger shares of BPL households, although there has been a substantial improvement with the introduction of

the state-level Rajiv Gandhi Awaas Yojna (RGAY) scheme in 2005–06. Household-level targeting analysis for the Public Distribution System (PDS) cards suggest that possession of BPL and Antyodaya Anna Yojana (AAY) cards are progressive, but there are significant inclusion errors, with households in the upper asset quintiles also possessing cards meant for poorer households (Figure 6.5).

**Figure 6.5: Geographic and Household Level Targeting of Programmes**



Notes: Left panel y-axis shows correlation between share of BPL population and share of programme funds, over time. Lower correlation indicates weaker geographic targeting. Right panel shows card possession among households in various assets quintiles, denoted by Q1 being the lowest through Q5 being the highest. Results are based on NCAER survey, 2004–05.



Overall, HP can be considered one of the better performing states in terms of implementation of social protection programmes, particularly with respect to introducing state-specific programmes to bridge perceived gaps and innovations within the limited scope of such centrally sponsored schemes. However, there remain several **current issues relating to performance** that are programme-specific and cross-cutting, and require attention.

- There is evidence of *administrative leakage* in some schemes. For the PDS, performance is positive in general, with higher ration card coverage and usage compared to national trends. However, the Planning Commission found that HP had a relatively high level of BPL cards which were not with their owners (described as “ghost BPL cards”), implying administrative leakages.<sup>82</sup> While the sample size of the study was small, this is an important criticism which warrants closer evaluation by the HP authorities. In addition, there is some evidence of irregular supply of food grains through the PDS, and of underweighted supply and dissatisfaction with the system.<sup>83</sup> The CAG report on SGSY suggests poor implementation performance in the state, including focus on individual Swarozgaris rather than Self Help Groups (SHGs), lack of provision of training and facilitation of bank and market linkages, poor targeting to SC/ST and BPL households, non-transparent beneficiary selection, and non-release of assistance.<sup>84</sup> For most other programmes for which assessments are available, notably for social pensions—the single largest intervention—leakage appears to be low, in contrast to a number of other states.
- The picture on *community participation* is mixed. On the positive side, GoI assessments indicate

a high level of community participation in identifying beneficiaries both for PDS and social pensions—the two largest interventions for the poor. However, there is little community involvement in the monitoring of PDS or in the selection of the beneficiaries under SGSY. The role of PRIs in several CSS anti-poverty programmes will become much more important in the future, especially with the expansion of National Rural Employment Guarantee (NREG), which currently operates only in Chamba and Sirmaur. As a result, attention will need to be paid to the implementation capacity of PRIs, and the appropriate level of the PRI system where functions will lie.<sup>85</sup> As the trend in programmes is towards greater roles for PRIs, HP, like other states, will need to develop its implementation strategy with this in mind.

- There are concerns about the *targeting of anti-poverty programs*, especially with respect to the large disparities between the distribution of BPL households across the state between the 1997 and 2002 BPL lists—the latter as yet to be officially approved. Reconciling these estimates in a way that is consistent with both local political economy demands and the need to keep the aggregate number of BPL households roughly constant (for the purposes of fiscal allocations from the centre) will be challenging.
- Poor record-keeping and the lack of effective *monitoring and evaluation* make it difficult to assess the overall working and impact of the various programmes. Despite apparently reasonable outcomes, basic record-keeping remains well below the level one would expect in a state of HP's income level and low beneficiary numbers.<sup>86</sup> In addition, and in common with many states of India, there is no robust impact

<sup>82</sup> Planning Commission (2005).

<sup>83</sup> Paul et al (2004).

<sup>84</sup> In its early years, only 13 percent of central and state funds released under this programme were utilized.

<sup>85</sup> The latter concern arises due to the small average GP size, with only about 1700 to 3000 population and inherently low capacity.

This is an important weakness highlighted in both the CAG and PEO reports on SGSY, IAY and PDS, which note the lack of records of houses constructed or repaired under IAY as well as the projects under SGSY.



### Box 6.2: Findings from an Evaluation of Social Pension Schemes in Karnataka

The Government of Karnataka (GoK) provides monthly financial assistance to the destitute through the Old Age Pension (OAP) and Destitute Widow Pension (DWP) schemes. In 2002–03, GoK paid out over Rs. 1 billion to about a million beneficiaries, each entitled to receive a stipend of Rs. 100 per month. At GoK's request, the Bank conducted an evaluation of the scheme in order to: (i) quantify the extent of leakages in public funds, in aggregate, and at various stages of implementation; (ii) examine the extent of over- and under-coverage, and effectiveness of targeting; and (iii) identify distortions that impede the service delivery process. The assessment finds that social pension schemes in Karnataka have both strengths and weaknesses.

*On leakages of public funds*, the study finds that state-wide leakage is low. Of every Rs. 100 that is spent on beneficiary payments (not including the costs of administering the programme), Rs 13 does not reach the beneficiary. However, there are wide variations across taluks, with about 20 percent of public resources not reaching beneficiaries in the problem taluks. To reduce leakage, a one time effort to delete fictitious pensioners is needed, backed by a few improvements in the Treasury Department's database management system and monitoring systems to ensure that leakages do not creep back into the system at a later date.

*On targeting*, the study shows evidence of "pro-poor" targeting, with coverage rates under social pensions falling sharply as wealth and assets increase. However, the lack of perfect targeting means that coverage among the poorest is much less than possible. To improve targeting, eligibility criteria should be revised and enforced.

*On the delivery process*, the study finds that although awareness of the programs is high, transaction costs of applying for a pension are a deterrent to potential beneficiaries. In contrast, once pensions have been sanctioned, the delivery of benefits works smoothly with minimal costs imposed on the beneficiaries.

evaluation of programmes which proceeds from a reliable pre-programme baseline or use of basic control/treatment approaches to evaluation. HP can strengthen record-keeping and basic administration of major social protection programmes, identifying and introducing lessons from other states on simple administrative improvements (Box 6.2). For all major programmes, HP could initiate periodic impact evaluations which go beyond the concurrent ex-post evaluations presently undertaken. A first step in this would be ensuring reliable pre-programme baselines whenever new interventions are launched.

- There is a *lack of linkages* between specific programmes and the broader rural livelihoods agenda of the government. Challenges of inter-departmental and public/private coordination

make this difficult at times, but leveraging the resources of the social protection interventions to enhance the impact of other livelihoods interventions could have significant dividends. Facilitating market linkages is particularly important in HP due to its mountainous terrain.

In addition, HP's income and development levels also suggest that it will increasingly face some **new and important second generation issues** in social protection in the coming years.

- First, coverage of *social insurance* remains very limited to date, with the notable exception of life insurance.<sup>87</sup> The most pressing social needs appear to be for some form of health/disability insurance, and old age security. In addition, improved crop and/or weather-based insurance

Analysis from various parts of India—including several which are much poorer than HP—suggests that demand for different forms of social insurance is significant among those in the unorganized sector who presently have no coverage.



may be increasingly important as HP expands into higher value but higher risk production. In both the government and non-governmental sectors, HP, to date, lags other states in the level of support and experimentation in efforts to expand social insurance coverage to the unorganized sector. While HP's fiscal situation suggests considerable caution on new commitments to insurance subsidization, the experiences of other states with different forms of non-subsidized or low subsidy social insurance products (e.g. Unit Trust of India's old age pension plan, which operates without subsidy in settings as poor as Bihar; Maharashtra's Mathadi Worker's Fund which is contribution-driven; West Bengal's Provident Fund for Unorganized Workers, which has achieved significant coverage with a modest contribution subsidy), and of the non-government sector offer useful models which may be worth piloting in HP.<sup>88</sup> HP can initiate pilots on a scale and with models that control fiscal exposure on subsidies, while exploiting the convening power of the government to bring public and private partners together.

- A second area where HP is already expanding services but where a strategic vision is to date lacking is *social care services for specific vulnerable groups*.

Initiatives which are already underway include old-age homes, houses for victims of domestic abuse, and orphans. These are areas where one would expect expansion in service provision as the population grows richer, demographic and lifestyle patterns change, and expectations from the population evolve. To date, coverage is small scale, but one concern is that responsibilities are being added in a somewhat piecemeal manner without a clear vision of the state's expected future role—in particular the optimal model of public/private mix in financing and service provision—nor with a more immediate eye on the staffing and resource demands implied. This can continue in the short run, but, in the medium term, would benefit from a policy-driven approach to expansion of services which draws on the experiences of the non-governmental and private sectors. Accordingly, GoHP could consider development of a social care service strategy for the state. Strategy development would be a useful process to develop consensus on the priority services for HP in the medium term, and a sustainable financing and delivery strategy. A critical element on the delivery side will continue to be played by the private and NGO sectors, and they should be close partners in developing such a strategy.

<sup>88</sup> Other states have taken group insurance policies with commercial insurers for specific groups for specified risks (e.g. Rajasthan with a group life insurance policy for all BPL; Assam with a group health and accident policy for all BPL).

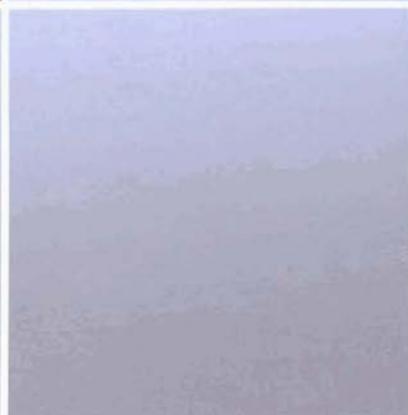
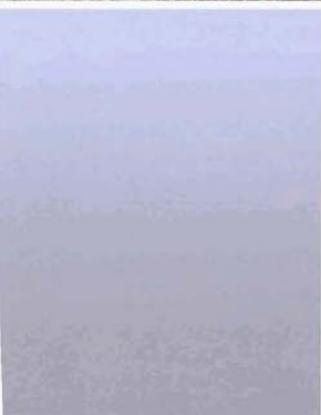
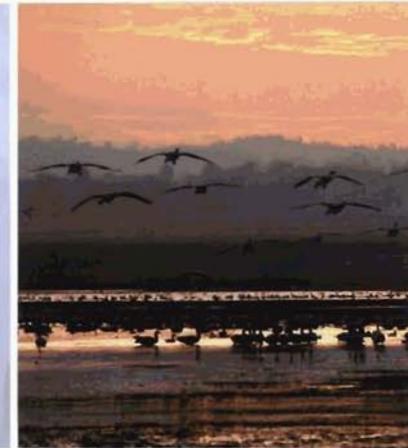






07

# Promoting Environmentally Sustainable Development





## Promoting Environmentally Sustainable Development

Sustainability of economic growth in HP is contingent upon sustainability of its environmental heritage. HP's key growth and revenue drivers in the medium term are critically dependent on the state's natural resource base. While some environmental degradation inevitably accompanies growth, inaction or failure to balance the environmental costs of development with the benefits will have particularly serious consequences for the state—whose opportunities lie in sectors like horticulture, tourism, and hydropower which depend on the environment. Given HP's unique geographic situation and small resource base, protecting rich natural resources assume greater importance than in other states. In addition, increased pollution can have implications for the entire Indo-Gangetic plains.

HP's recent development pattern and trend have had some worrying impacts on the environment. While forest cover has increased in recent years, the quality and

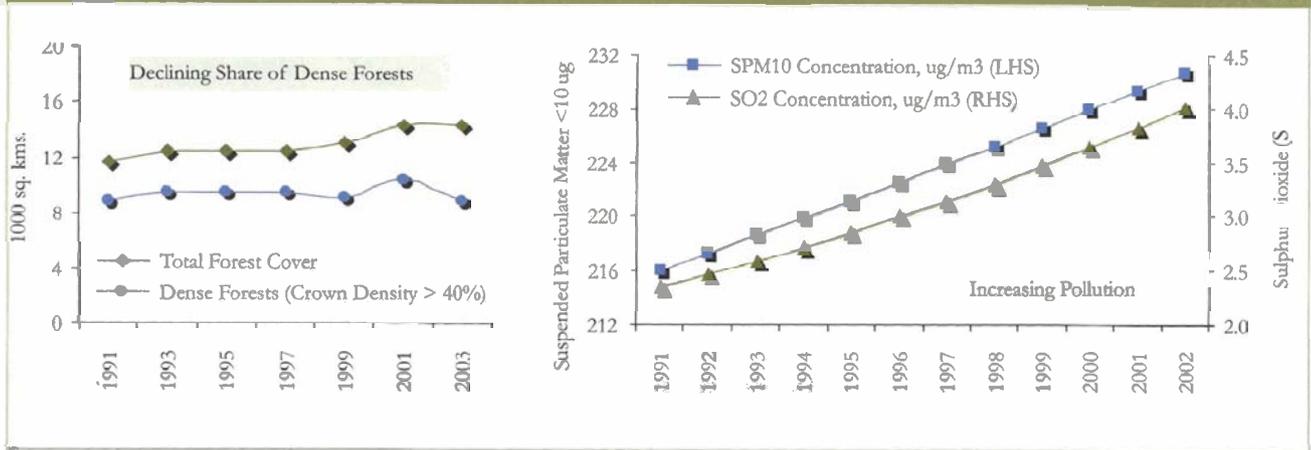
density of the cover has diminished—as has the economic productivity, water holding capacity, and the ability to sustain species richness (Figure 7.1). Recent years have also witnessed rising pollution levels (Figure 7.1), with increase in human and livestock population, pressures of urbanization and industrialization, and increased health hazards. These disturbing trends need to be addressed by GoHP.

HP has introduced a number of commendable new initiatives to address the growing threats to its fragile ecology, though there remain issues around implementation. These initiatives include: (i) broadening the State Pollution Control Board's (SPCB) regulatory role to include environmental auditing, micro/macro level environmental planning by which zoning atlases have been completed for five districts, the preparation of district level industrial siting guidelines, and industrial estate planning studies;<sup>89</sup> (ii) establishment of a Special Area Development Authority to implement the approved

<sup>89</sup> The five districts are Shimla, Kullu, Kangra, Kinnaur and Chamba



**Figure 7.1: Recent Environmental Degradation in HP**



*Notes:* Forest data from Department of Forests, GoHP. Pollution data from Central Pollution Control Board.

notified development plans; (iii) implementation of a ban on polythene bags of certain dimensions with effect from June, 2004; and (iv) segregation of non-biodegradable waste.<sup>90</sup> The major concern remains the weak implementation of regulations. There is an over-reliance on command and control regulations which are cumbersome and costly to enforce.

## A. Improving the Institutional Approach for Environment Management

Environmental management is an interdisciplinary field requiring cross-sectoral decisions and coordination for effective management, in the absence of which most development activities can induce significant and irreversible changes with adverse environment implications. In *hydropower*, land use change, catchment

area degradation, landslide hazards, aquatic life patterns and hydrological changes, and poor muck disposal affect eco-sensitive areas with high tourist potential. In *industry*, there is a neglect of environment planning, such as clustering of like industries for effective environment management solutions for industrial (also hazardous) waste. Further, small scale industries are primary violators as they generally do not have enough resources to invest in environment protection measures. In mining, slope degradation due to weak implementation of rehabilitation plans, and pressures caused by the influx of workers affect the environment, with more violations from small scale mining units. In *forestry*, the current ban on green felling has had an adverse impact on forest quality due to constraints on maintenance works, in addition to unsustainable extraction of forest resources, excessive grazing due to a growing livestock population, conversion of forest lands to agricultural, and diversion of biodiversity rich forest lands due to hydropower and mining.<sup>91</sup>

<sup>90</sup> Draft "State of the Environment Report", Himachal Pradesh, Coordinated and prepared by State Council for Science, Technology & Environment, Sponsored by the MoEF.

<sup>91</sup> For example, it is estimated that while 1.9 million cubic meters of fuelwood is consumed each year, regrowth is a mere 0.7 million cubic meters, implying considerable depletion of forest stocks.



In *agriculture and horticulture*, there is danger to the environment from shortage of ground water sources, pollution from chemical pesticides, and inadvertent introduction of new weeds which may be harmful to human and animal health. In *irrigation and public health*, there are environmental threats from degradation of sub and surface water quality, source protection and contamination due to unhygienic ways of handling water and poor sanitation, neglect of traditional water sources, and conflicts between upstream and downstream water users which are exacerbated due to weak community ownership of water resource management and monitoring. In *health*, weak hospital waste management could lead to other health hazards. There is a trend towards *urbanization*, with the urban population growth at an annual rate of about 3 percent over the last decade. However, much of this growth has been without a coherent strategy, poor solid waste disposal mechanisms, weak enforcement of zoning and building standards, unreliable water supply, and congestion which has contributed to ecological and cultural decay and poor quality of life in urban centres. In the *transport and roads sector*, opening access to eco-sensitive areas, poor construction practices and debris disposal mechanisms, land use change, slope destabilization, pressure on resources caused by influx of large construction crews, congestion and air pollution due to poorly managed transport systems, improper fuel mix, and inefficient combustion of vehicles causes overall environment degradation. In *tourism*, weak planning and management, unplanned expansion, and burdening of existing tourist areas are contributing to ecological damage and a negative perception of HP as a tourist destination.

Given that the natural environment heritage is critical to HP's development plans, it is important to consider it as a key planning criterion. Institutional aspects of environment management typically involve interagency coordination, and involvement of affected groups, communities and NGOs.<sup>92</sup>

## Better Intersectoral Coordination and Mainstreaming of Environmental Activities

### Key Challenges

Despite such externalities, the current institutional approach to environment management is fragmented, with environment considerations not consistently internalized within sectoral departments, given limited priority, and perceived more as a "clearance" requirement rather than planning criteria. Moreover, the Environment Department is at a very nascent stage of establishment, currently housed as a small, one-member wing within the Science and Technology Department, and not geared to influence development decisions from an environmental perspective. Further, the SPCB is a separate entity, mandated, as per the Environment Protection Act and Rules, to monitor environmental norms for typical industrial activities (including housing). The Forest Department is mandated, per the Forest Conservation Act, to monitor green cover. The state relies mainly on clearances from these departments for environment preservation.

Weak intersectoral coordination and decision-making between departments leads to unsustainable outcomes which then adversely affect the natural and social environment, even though some coordination mechanisms are in place. There are examples of inter-departmental disagreements in HP—such as between the Departments of Power and PWD on the construction of roads (timing, alignment, and debris disposal), and the Departments of Power and Forests on the definition of catchment area; and weak linkage between the Departments of Mining, Industry, Forest, and Revenue in the context of licensing and implementation/monitoring of quarry rehabilitation plans. The urban scenario also reflects disconnects in implementation and enforcement of urban area development plans, given the involvement of multiple

<sup>92</sup> World Bank Technical Paper No. 139, Environment Assessment Sourcebook.



agencies (Town and Country Planning, IPH, Art and Heritage) with minimal participation from the people. There are frequent violations of building standards—with regularization every three years which encourages further violations. Issues such as safe, commuter-friendly road designs, public transport, air quality due to congestion, parking places, wayside amenities, and bus shelters are not effectively addressed due to Transport and PWD (for roads) being two separate Departments, without enough coordination between the two.<sup>93</sup> Although tourism is high on the state's growth agenda, there is no systematic method to address overall tourism needs in spite of the interdependence of the sector on line agencies such as Forests for access to eco-sensitive areas with high tourism potential, PWD for roads and connectivity, and Power and IPH for reliable electricity and water supply.

### Strategic Options

Accordingly, there should be better **intersectoral coordination** to improve the fragmented institutional approach to environment management. The state can consider a number of mechanisms in this regard.

- It would be useful to look at measures to *strengthen the Environment Department* and develop capabilities which would help to systematically assess how the state can maximize its natural advantage, and to ensure application of environment norms across sectors. The state can consider redeployment of surplus staff from other departments for administrative functions to minimize fiscal costs, although limited specialist staff may need to be hired.
- Informed and strategic policy making is not possible without information on critical issues, so *improving the information database* in at

least the key sectors which have wide ranging environmental consequences, and enhancing the dissemination of this information, should be a high policy priority. In this area, HP can build upon recommendations from the State of the Environment Report.

- The state is considering the preparation of an “Environment Plan” and an *Environment Policy* which may help bring convergence of sectoral targets and development goals, and provide a holistic view with respect to implications on natural resources and environment-carrying capacity.
- Specific *coordination agencies*—like the Tourism Development Board that has been constituted headed by the Chief Minister to ensure convergence and avoid intersectoral conflicts—should be established and strengthened.

Furthermore, it is important to better **mainstream** environment considerations in various sectoral activities, instead of regarding it as a “clearance” function to be obtained from various departments and boards. In order to strengthen this aspect, the following actions could be considered in various sectors. In *hydropower*, it would be useful to follow an integrated river-basin wide approach towards preparation and expeditious implementation of activities such as project allocation, Catchment Area Treatment Plans, Compensatory Afforestation, Net Present Value (NPV) money for use of forest land and biodiversity offsets.<sup>94</sup> In *industry*, environment planning, such as clustering of similar industries, would ease environment management solutions. In *tourism*, it is important to develop mechanisms to detect environment conflicts resulting from cross purpose implementation of development policies and projects, through strategic planning to demarcate areas that have tourism potential

<sup>93</sup> However, the Public Works Department (under the World Bank financed State Roads Project) is in the process of adopting ISO 9000 on quality control and ISO 14001 on Environment Management—thus internalizing environment management within the department, considerably reducing the reliance on monitoring by the State Pollution Control Board, which is not mandated to monitor poor construction practices, material management, and debris disposal etc. The Department also plans to experiment with bio-engineering as an alternative technology to address slope slips and failures.

<sup>94</sup> See Section B below for further details.



vis-à-vis those for purely development needs. Promotion of eco-tourism, in particular, is closely linked with environmental resources, and can provide important economic returns as in diverse countries like Australia, New Zealand, South Africa, Kenya, and Tanzania. In *forestry*, an independent environment regulator could ensure that development activities are carried out according to the original Memorandum of Understanding (MoU) with various line agencies, and environment assessments are carried out for multi-development works.

The state could also experiment with an **area based environment management approach**, which could be a potentially valuable tool for a fragile hill state. This provides a way of clustering industrial pollution sources and so: (i) restricts the pollution footprint to a predefined area and provides a cost effective way to mitigate and restrict the damage to the area; (ii) allows for a scientific assessment to prioritize among multiple pollution sources, a consensus-based stakeholder process to establish environmental and community goals, and the integration of diverse management options to address the cumulative impact on the ecosystem. In practice, this approach has had mixed success across the world.<sup>95</sup> It is important to learn from these experiences, emulate good practices, and improve the effectiveness of this tool within the institutional framework for environmental management—likely by linking it with the decentralization process and local government agenda, strengthening the authority of municipalities and regional development authorities, and enabling them to facilitate integration of multiple sectoral strategies and stakeholders.

## Improving Environmentally Responsible Public Participation

Public participation in environmental decision-making is low in HP and the state needs to improve this. The recently concluded India Country Environment Analysis reveals that effective enforcement requires and is strengthened by informed consensus on environmental management objectives and policies, based on a good understanding of the shared roles and responsibilities of all players, including the regulator, the regulated community (developers and polluters), and the affected community (general public).<sup>96</sup>

Moreover, environmental management is not only an issue of fixing regulatory institutions—but intricately linked to the behavior and responses of the private sector. An incentive-based mechanism to protect the environment can be adopted, whereby the private sector is motivated to behave responsibly through a “carrot-and-stick approach”. National examples also suggest the importance of community participation, through incentives and rewards for environmentally responsible behavior (Box 7.1). Penalizing polluters on one hand and rewarding those that meet international environmental standards in their private sector operations on the other may be necessary, as the state cannot enforce all environment-related activities.

Public participation could be effectively used by improving communication and trust among stakeholders; maximizing the effectiveness of the Right to Information Act (RTI); providing credible and easily accessible information; developing public participation strategies in the context of a specific

<sup>95</sup> A review of Indian experience highlights several lessons, including the need to: (i) involve a wider range of stakeholders in such programmes, and particularly better define the role of affected communities in the monitoring process; (ii) establish adequate performance indicators, linked to environmental quality improvements in the area, and not simply implementation of measures by individual polluters; (iii) strengthen oversight of implementation and incentives for polluters to complete the actions speedily; and (iv) better integrate area-wise sources in the programme, including both non-point and point sources. Some of the most successful international examples include those where an appropriate coordinating “area-based” authority was established with adequate powers, such as river/lake basin or coastal zone management agency (e.g. Laguna Lake Development Authority in Philippines), or city-level air quality councils (e.g. Mexico).

<sup>96</sup> World Bank 2006, India Country Environment Analysis.



### Box 7.1: World Bank Involvement in Environment Management

Himachal Pradesh is known for its wealth of natural resources and rich cultural heritage. What this popular perception overlooks is the ecological fragility of the Himalayas. The economy is largely agrarian, and majority of arable land in the state is rainfed.

After the success of \$ 135 million IDA/IBRD funded Integrated Watershed Development Project which closed on September 30, 2005, the World Bank has worked with GoHP to prepare a repeater project called the Mid-Himalayan Watershed Development Project which became effective in March 2006. The key objective of the project is to reverse the process of degradation of the natural resources base and improve the productive potential of natural resources and incomes of the rural households in the project area. The secondary objective is to support policy and institutional development to harmonize watershed development projects and policies across the state in accordance with best practices.

The project aims to achieve these objectives by: (i) setting up local institutional mechanisms that would strengthen capacity and help villagers manage their own resources; (ii) introducing water harvesting technologies and treatments (such as plantation, protective irrigation, fodder production and soil conservation and catchment treatment measure); (iii) creating employment opportunities to redress of socio-economic and gender inequalities; (iv) restoring ecological balance by harnessing, conserving, and developing natural resources, i.e. land, water, and biomass; and (v) developing infrastructure to improve connectivity and accessibility to markets, and promoting agri-business.

The project is implemented through an independent society called the "Mid Himalayan Watershed Development Society". The partnership between the project and the Forest Department has helped in promoting a major shift towards a more decentralized and community-oriented forestry approach, rather than a conventional conservation strategy. Community-centered, sustainable, and equitable management systems have been put in place through local governing bodies called the Gram Panchayats (GPs). Around 600 GPs are likely to be included under this project. Another important guiding principle used under this project is the multi-stakeholder approach with active partnership from the Departments of Agriculture, Horticulture, Rural Development, and Forest. In order to facilitate different watershed activities, a Natural Resource Management Society (NRMS) was established as part of the project preparation process. The primary objective of the NRMS is to provide policy guidelines for effective coordination among different line departments responsible for the watershed development activities in the state. The project has completed its first year, during which community mobilization, micro-plans, capacity building for PRI and user groups, and base line surveys are some of the key intervention undertaken as part of the implementation process.

To facilitate the afforestation in the Himachal Pradesh Mid-Himalayan region, the project has recently introduced an additional component called the Bio-Carbon Conservation sub-project. Under this component, around 12,000 hectares of non-arable land, degraded forest land, and degraded common property land will be used for plantation. Farmers will not only receive cash incentives for afforestation work by selling carbon credits, but also get direct benefit of fuelwood and Non Timber Forest Products. The main objectives of this component are to: (i) sequester or conserve greenhouse gases in forests; (ii) restore degraded land by afforestation; (iii) establish viable biological connectivity among several currently isolated forests and protected areas; and (iv) improve the livelihoods of the farmers.

development project and with sensitivity to the local situation; building government agency capacity for more effective public consultation and participatory decision making; broadening the understanding and strengthening the capacity of local governments in

environmental decision-making; sensitizing sectoral agencies and developers to the need for meaningful public participation; building civil society institutions and capacity to understand; and exercising a participatory action planning process.<sup>97</sup>

<sup>97</sup> World Bank 2006, India Country Environment Analysis.



## B. Sustainable Hydropower Development

Hydropower is a key resource of the state, and can be a major source of non-tax revenue, as described above. It is particularly important that hydropower be developed in an environmentally sustainable manner. Injudicious exploitation of the state's hydropower resources can pose a threat to the state's natural resources. As the development of the significant hydropower potential of HP advances to a mature stage, concerns pertaining to optimal planning for the development of the state's river water resources and the long-term sustainability of this development will come to the fore.

The project-based approach currently in use by the state (and throughout India) will be inadequate to address these concerns. With the entry of the private sector as well as a number of relatively new public sector agencies into hydropower generation, HP is increasingly experiencing the situation where projects in the same river basin are assigned to a number of different public and private operators. This approach to allocating projects could eventually give rise to controversy or conflict, as the differing owners/operators could have different priorities for the quantum of exploitation of the water resource available to them, and there may be differing views on the actual use of the water held by local communities, environmentalists, and other interest groups. Eventually, as the revenues from power sales become significant, it is normal to expect the emergence of competing views on the use of these revenues in the context of the public discourse on the budget.

In order to manage these processes, GoHP, as the steward of these significant resources, may find it useful to move beyond the present planning paradigm based on the individual project to a more holistic approach

to development based on river basin management as a whole, that incorporates the environmental and social aspects as integral to the process of development. There are many aspects of management on the level of the river basin which are crucial for sustaining revenues and the long-term operability of projects, but which are not adequately reflected when development is viewed from the perspective of individual projects. Examples of this include management of the river catchment area; management of sediment in the river bed; management of social and environmental impacts; and the implications for the entire river basin of the long-term evolution of basin hydrology and river geomorphology, including the possible impact of climate change.

A potentially positive development is the recent establishment of a *Forum of Hydropower Producers of Satluj Basin* in order to achieve common goals and objectives for harnessing the hydroelectric potential of the Satluj basin in an eco-friendly manner, and to ensure the development of the area including welfare of people.<sup>98</sup> The state could facilitate a river basin study for the Satluj basin as a starting point, and prepare an implementable Action Plan that could promote sustainable development of the hydropower resources along the dimensions outlined below.

### Institutional Arrangements for River Basin Management

In order to promote effective institutional arrangements for river basin management, the state could consider creating a specialized agency with a broad mandate for overseeing the development of the major river basins. Another important benefit of a river basin agency with a mandate for coordination is the positive role the agency can play in facilitating the work of investors with other governmental agencies in specific areas of

<sup>98</sup> The members of the forum are - Bhakra Beas Management Board (BBMB), NTPC Ltd, Himachal Pradesh Electricity Board (HPSEB), Satluj Jal Vidyut Nigam Ltd. (SJVN), Jai Prakash Hydropower Limited (JPH), Himachal Sarong Power Ltd., and Nuzivedu Seeds Ltd.



relevance to project development, e.g. land acquisition, implementation of environment management plans, resettlement and rehabilitation aspects, etc. In a well-functioning agency, this would facilitate the overall project implementation process and give assurances to investors, contributing to the mitigation of the significant risks generally perceived to be associated with development of hydro projects. The following points must be considered with respect to a river basin management agency.

- Common *institutional models* follow a two-tiered management and governance structure, whereby political support and policy decision-making are separated from technical and managerial functions. The design of a river basin agency model for HP would need to assess and address the specific issues of operations across departmental and administrative jurisdictions and include mechanisms of conflict resolution. Given the highly technical nature of the expertise required to operate such an agency, it will be particularly important to ensure the insulation of the technically-based decisions from political pressures.
- Basin institutions can be advisory in nature but they may also include planning, construction or management in their mandate. The mission of the agency must define the *fields of activity*, which may include flood management, social and environmental management, disaster planning, etc., in addition to hydro development.
- Basin institutions can also help facilitate putting in place mechanisms for *cost-benefit sharing* between projects within the same basin, for example, in a scenario where an upstream storage project could complement several downstream projects with increased generation during lean season.
- Identification and incorporation of *stakeholders* is crucial for ensuring that all interests are represented, that the adequate legal authority is vested, and that adequate financial resources are made available. It is also important

to realistically assess the requirements of driving the change agenda, and to include the institutional actors accordingly.

A practical starting point could be the creation of a working-level forum for the coordination of existing projects on a given river basin and to finance its growth over time through earmarking a small portion of the revenues from projects as they enter commercial production. Where such forums already exist, they should be institutionalized and given a formal role.

## Hydropower Planning

One of the key issues in the planning for the development of the Himalayan rivers for hydropower generation has been the relative dearth of storage projects, with preference given to small and medium-sized run-of-river projects. Under certain circumstances, storage projects could be the economically preferable alternative, as long as adequate provision can be made for mitigating the generally greater environmental and social impacts of the project. The storage projects can provide significant benefits in terms of drinking water availability, peaking power generation and silt management.

In current practice in India, the decisions regarding the siting and capacity for the hydro project allocations are generally not supported by river systems analysis. This can lead to sub-optimal planning whereby benefits are foregone due to under-realization of hydro potential. A strong river basin management agency with good analytical capacity could help rectify this shortcoming of the planning process.

Better hydropower planning could be adopted, with decisions regarding the siting and capacity for hydro project allocations supported by river systems analysis. There is an important role for the state in identifying and encouraging storage projects for possible future development, and this function could be assigned to a river basin management agency. The state could



investigate opportunities for economically viable storage projects and, where identified, facilitate their development while ensuring adequate risk mitigation towards environmental and social impacts.

## Environmental Management of Hydropower Development

One of the most challenging and controversial dimensions of the development of the Himalayan rivers, including the rivers of HP, is the environmental impact of the development projects. Given that this is a major sector that GoHP wishes to expand in the medium term, particular attention needs to be paid to ensure that hydro projects are developed in an environmentally sustainable manner. Injudicious exploitation of the state's hydropower resources can pose a threat to the state's natural resources. Delay in or improper implementation of environmental management activities falling within state's domain is a threat to the larger environment. In HP, this is important not just for assuring stewardship, but also because of the negative external impacts on the growth prospects of other economic sectors.

The track record of GoHP's agencies, notably the Forest Department, in implementing Environment Management activities—like the Catchment Area Treatment (CAT) plan, Compensatory Afforestation, development of fisheries, conservation of wildlife, etc.—related to hydropower projects in the state is modest. In order to promote sustainable development of the sector, it is important to take steps to improve these activities, as discussed below.

**Catchment Area Treatment (CAT)** is critical, but instead of using a river-basin approach, the current approach of preparation and implementation of CAT plans is piece-meal. A uniform approach to the preparation and implementation of the CAT plan, rather than the current piece-meal approach that divides responsibility for the CAT plan among the individual projects, would have direct technical benefits,

as removal of sedimentation is one of the major operational problems faced by hydropower generation plants on rivers in the Himalayas. In order to improve the framework for environmental management with regard to hydro development, the state could reform of the practice of preparation and implementation of CAT plans using a river-basin approach, consider alternative methods of implementation (e.g. through outsourcing, through project developer, etc.), and ensure the activities are completed in synchronization with project completion.

Any delay in the **implementation of the environmental management activities** (such as CAT plans, compensatory afforestation) falling within state's domain is a threat to the sustainability of the environment. It is critical to ensure that these activities are implemented in synchronization with the project implementation schedule so that maximum benefits are available to the stakeholders. Given the limited capacity of local government institutions and agencies (e.g. Forest Department) to implement environmental management activities, it may be worthwhile to consider such innovations as outsourcing this responsibility or making the project implementing agency responsible for carrying out the activities under the CAT plan and other important tasks in the area of environmental management. In parallel, it would be advisable for the state to put in a place a plan for building up capacity of state regulatory agencies for implementing and supervising such activities—such as the SPCB and the Forest Department.

The current approach of applying a **uniform minimum ecological water flow requirement** irrespective of the project site and other considerations is inefficient to the extent that the actual requirement (i.e. what is needed to achieve the stated objective of the minimum flow) at any given location may be higher or lower than the arbitrarily determined uniform norm. If the uniform norm is higher than the actual requirement, then there would be a loss in the benefits of electricity generation. On the other hand, if the uniform norm is lower than



the actual requirement, then there would be a failure to achieve the stated objective of the minimum ecological flow. Flexible norms that are determined on the basis of site-specific analysis would lead to outcomes that are preferable from both a technical and an environmental perspective. The role of the government, then, should be not to determine uniform norms, but to specify the nature and quality of the environmental analysis to be carried out at specific sites in order to come to the determination of the minimum ecological flow requirement for the concerned section of the river. Accordingly, the state could introduce flexible, site-specific norms for minimum ecological flow—where GoHP determines the nature and quality of the studies required to make the site-specific determination

Given the increased global focus on “low carbon” technologies for generating power and the significant role hydropower can play towards that end, the state may also wish to consider measures to encourage use of carbon finance as a potential source of revenue towards mitigating the costs of the risks associated with development of hydropower. While the likelihood of future projects being commissioned and becoming eligible to receive carbon revenue before the end of the first commitment period under the Kyoto Protocol, in 2012, is low, negotiations are on-going for the second commitment period, which may provide important opportunities for HP.

## Social Inclusion and Benefit Sharing

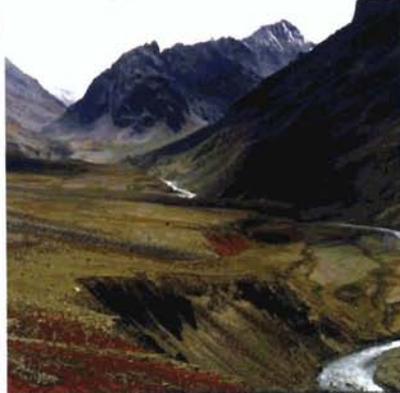
Local communities are the most directly affected by the development of hydropower projects. The disruption to community social and economic life during the construction phase is often considerable and can take a variety of forms; during the operation phase the impacts are typically less severe. In the case of the main rivers of HP, the development activity that will impact on specific communities is likely to continue for many years, as many projects are slated for future implementation on the small number of major rivers in the state.

It is because of the disproportional impact on local communities, sometimes including the permanent loss of the use of the water for other purposes (at specific locations), that benefit-sharing mechanisms have been developed as a means of ensuring sustainable and equitable development, and of ameliorating potential opposition to development that could emerge in the absence of any benefit-sharing mechanisms.

In its efforts to ensure sustainable, equitable and socially acceptable development of the state’s rivers, one alternative for GoHP to consider would be to give local communities (which would have to be explicitly defined at the outset) a share in the specific project benefit streams over time (i.e. a part of the power royalty collected by GoHP). The financial cost of this will be very small compared to the revenue streams of the project, as overall project returns are generally high, and the communities concerned generally small in terms of population. The positive impacts for local social and economic development should also help build public support for Government’s hydropower development program. There are various models that GoHP could consider to help build local communities’ and local administration agencies’ limited capacity to manage revenue streams and decide on development priorities. In one such model, local area development activities would be implemented through the project implementing agencies themselves, with the selection of schemes and their monitoring the responsibility of a body with representatives of the project authority, affected villages/panchayats and the local district administration.

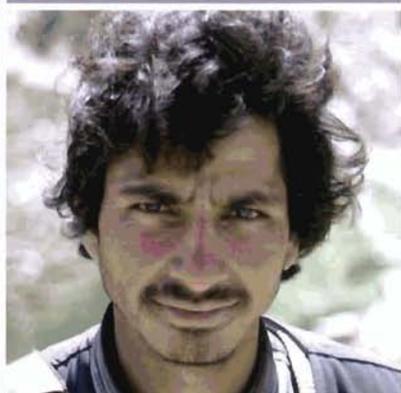
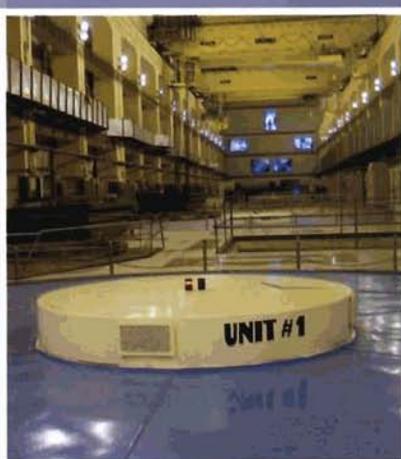
Contemporary river basin agencies engage their communities through active and managed processes of involvement to generate a sense of ownership and to ensure that the development processes and outcomes meet the needs of the communities. Community participation mechanisms will need to be carefully selected based on the nature and level of community participation that is deemed desirable and feasible.





08

# Implementing and Sequencing the Reform Agenda





## Implementing and Sequencing the Reform Agenda

It is clear from the preceding discussion that, in spite of commendable recent achievements, HP faces several challenges to achieving its development priorities of sustainable and inclusive growth. This Report has analyzed some of the key challenges in restoring fiscal sustainability, promoting private sector participation, exploiting opportunities in the emerging sectors, improving public administration and service delivery, protecting the environmental and ecological heritage, and further improving human development and social protection strategies.

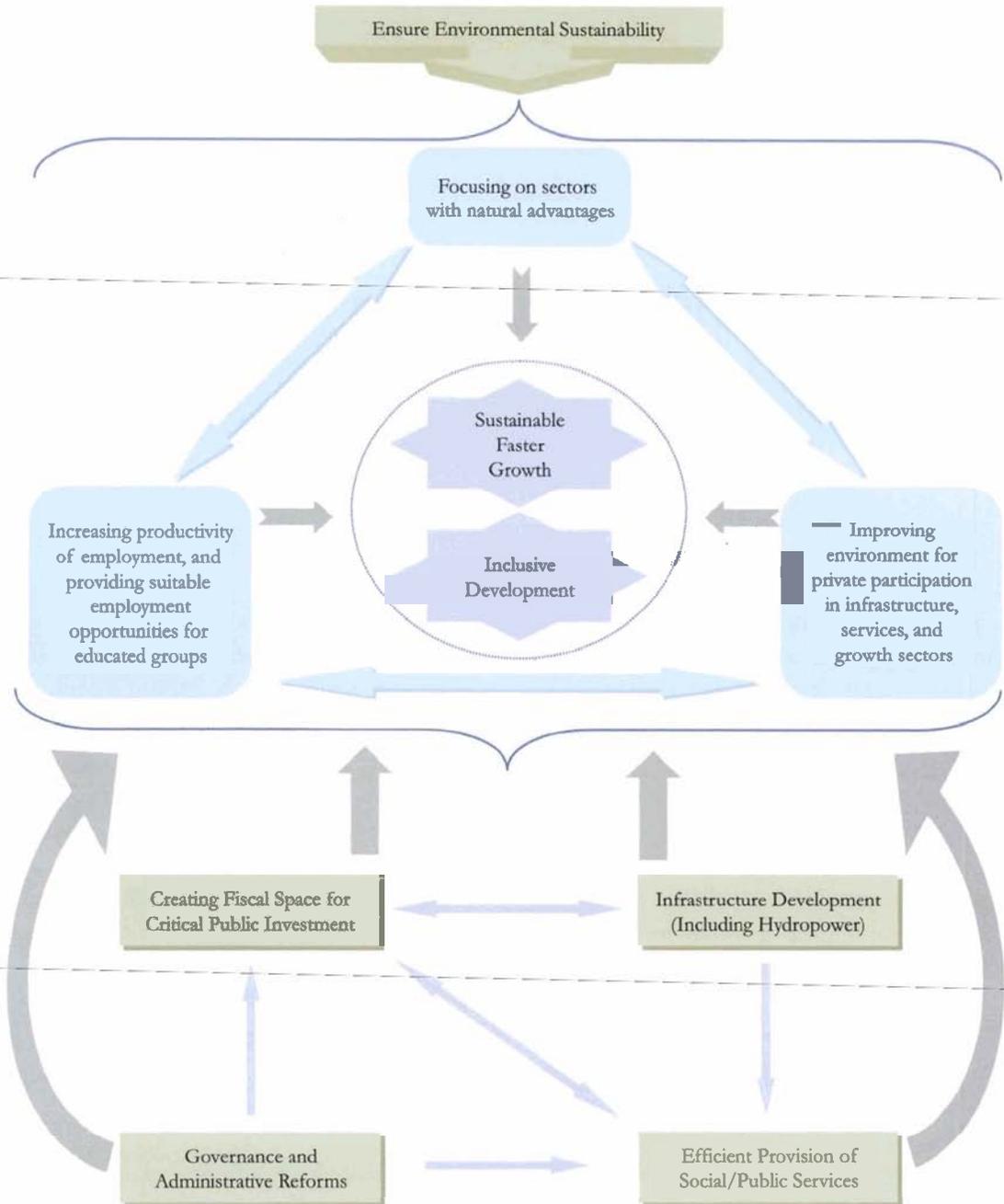
The Report has suggested various reform options for GoHP to consider in addressing these challenges. The menu of reform options is based on the Bank team's understanding of constraints and reform priorities that is mostly already under consideration by GoHP. While these are all considered vital policy measures, the assessment recognizes that they may not all be implementable immediately from the view of political feasibility, and that actions internal to GoHP could be undertaken more easily than reforms involving changes in national policies or those requiring wider consultations.

The broad elements of a possible development strategy for the state are summarized in Figure 8.1. The agenda is large, and will need to be executed over a substantial term time span. However, it will be to HP's advantage to begin the process soon—identifying some of the priority areas. Several reforms proposed in the Report are administrative in nature, and, where sufficient background material and models already exist they can be implemented without delay. Others require a cross-cutting approach, and prioritization and sequencing should be guided by the exigencies of the situation and the complexity of the requirements. If proposed policy measures require more preparation and internal consultations within the state, involving various stakeholders, GoHP should begin the process.

Given the complexity of the task, a flexible approach is suggested by which GoHP identifies those reforms which are the most pressing, implementable, and likely to yield significant returns, in order to develop a cohesive programme that is reflective of and consistent with the state's vision. GoHP could also guide the proposed sequencing of reform actions. As a first step,



Figure 8.1: Proposed Elements in HP's Development Strategy



**Notes:** The state's twin priorities are sustainable faster growth, and more inclusive development. It needs to focus on sectors with growth potential like tourism and horticulture, promote private sector participation in various aspects of development, and improve productive employment opportunities. This could be achieved through suitable policies, civil service reforms, and infrastructure development (including hydropower) which could all help create fiscal space for critical public investments, and help achieve the state's development objectives. The state's environmental heritage has to be preserved, while the development priorities are pursued.



this assessment suggests that GoHP addresses the fiscal constraints on a priority basis—backed by governance reform measures to curb the salary bill. The state should take steps to promote sectors with untapped potential—and could consider measures for hydropower and tourism development as priorities. Simultaneously, measures to conserve and protect the environmental heritage—both in the context of hydropower development, and in terms of beginning the process of developing an Environment Policy—should also receive priority attention. At the same time, it would be important for GoHP to take steps towards making the transition from a state-led to a private sector oriented economy, and it is important to signal clear intent in this area. In order to address employment issues, GoHP should begin the process of assessing and projecting skills and education requirements.

While the Report assesses that certain reforms could precede others, this is not to suggest that other measures are unimportant. In particular, since social and human development outcomes are superior to most other states, reforms in this area could follow more pressing policy needs—but measures to improve quality and access should not be ignored. The critical issue is to develop a credible overarching and coherent medium-term strategy for the state to guide reforms along various inter-related dimensions, so as to meet the stated development objectives of sustainable growth and inclusive development. Reforms should ultimately be adopted by GoHP with the medium terms agenda in view.

## A. Proposed Reform Options

The following reforms are proposed for implementation over the short to medium term.

### Sustaining the Fiscal Recovery for Growth

The Report identifies the fiscal situation as a major constraint that the state must address, in order to realize its development priorities. The assessment has

accordingly identified a number of areas where GoHP could introduce policy reforms.

- As a first step, the state must refine its **medium term fiscal projections**, incorporating a clear policy basis, demonstrating, for instance, expenditure reallocation to capital outlay and non-wage O&M in critical areas, and to reflect stronger reform outcomes consistent with TFC recommendations.
- In order to strengthen the **budget formulation process** to better link policy goals and resource allocation to embed the medium-term perspective in budgeting, a fiscal strategy paper could be presented to the Cabinet preceding the budget preparation process—which will result in the communication of departmental expenditure ceilings and fiscal projections as part of the budget call circular.
- In order to enhance **own-tax revenues**, the state could: (i) switch from a specific to an *ad valorem excise* duty structure, as in Maharashtra; (ii) simplify the *license fee* structure for alcohol vending; (iii) initiate a review of the *motor vehicle tax and fees* regime with a view to raising specific rates of the motor vehicles tax, revamping fees for permits, registration, licenses, and fitness certificates, and introducing a ‘green tax’; (iv) re-introduce the *Professions Tax*; (v) begin evaluation of *VAT implementation* with a view to streamlining and strengthening VAT administration; and (vi) initiate an analysis of *stamp duty evasion* schemes and their revenue impact to prepare for a more fundamental reform of the stamp duty system, and reduce registration fees on par with other states
- In order to enhance **non-tax revenues** from user charges, GoHP could establish a Public Tariff Commission for various services like transport, education, health, water, and irrigation in order to depoliticize the determination of user charges.
- In order to improve provisioning, control, and composition of **expenditure**, GoHP could: (i) first complete *pension projections* for government and public sector agencies, and begin annual budgeting on an actuarial basis;



- (ii) implement an effective *wage and hiring* policy consistent with fiscal sustainability;
  - (iii) introduce a *contributory pension scheme* at par with government employees for new employees, with pensionable pay, in Public Sector Boards, Corporations, Universities and Local Bodies;
  - (iv) appoint a *Committee* to examine containment of expenditure under subsidies, a gradual phase out of non-merit subsidies as announced, and present a roadmap for subsidy containment, and implement recommendations;
  - (v) reduce *power subsidies*, and delink it from the power tariff;
  - (vi) initiate the process of identifying schemes that have lost relevance, and restructure and rationalize them by constituting an *Expenditure Review Committee* to critique ongoing schemes; and
  - (vii) *reallocate expenditure* towards non wage O&M expenditure in critical sectors, and capital outlay.
- In the area of management of **debt and contingent liabilities**, GoHP could: (i) merge *off-budget borrowings* with budgeted borrowings, and eliminate future off-budget borrowings; (ii) *risk-weight guarantees* and begin reporting; (iii) revise the *target for risk-weighted guarantees* under the FRBM after eliminating off-budget borrowings; (iv) establish a set of *formal rules* to govern eligibility of PSEs, cooperatives, and statutory boards for government guarantees, taking into account financial statements, record of profitability, performance on past guarantees, priorities of government, etc.; and (v) make progress towards the implementation of the reform strategy for *state-owned PSEs* outlined by the government in its order dated October 20, 2000, including initiation of the preparation of a turnaround plan for HRTC.
  - GoHP could initiate measures to modernize **tax administration** by considering, for example: (i) creation of the necessary *organizational basis* for separating and strengthening the key tax administration functions of registration, audit, collection, and taxpayer services; (ii) introduction of multiyear strategic *planning processes* underlying annual business plans, defining the mission and vision of the revenue administration, identifying the challenges and reform priorities for the planning period; (iii) improvement of the *accountability mechanism* to move from collection-based accountability to wider reforms like better quality of services and information provided to taxpayers, increased integrity, broader tax net, or reduced time required for registration of a business for tax purposes; (iv) strengthening of the *human resources* in the Excise and Taxation Department; and (v) making the Excise and Taxation Department the basis for a *unified tax collection system* so that other revenue-collecting agencies could then concentrate on their core, non-collection functions.
  - In the area of **public financial management and procurement**, GoHP could: (i) *modernize* the Himachal Pradesh Financial Rules, 1971, which need to be updated and simplified, (ii) replace the existing Procedure & Rules for the Purchase of Stores with a *public procurement law* that can apply to all procurement undertaken using public funds (goods, works and services), and which can be piloted in 2–3 departments and PSEs to ascertain the benefits; and (iii) roll out *treasury computerization* to cover the entire state.

## Improving the Investment Climate for the Private Sector

In order to promote private sector participation so that investments in the state continue beyond the phase out of special incentives in 2010 and the burden on the state as a provider of employment is reduced, efforts need to focus on the key constraints as identified in the short survey undertaken for this Report: improving road infrastructure, addressing skills mismatches, and strengthening the urban infrastructure.<sup>99</sup>

<sup>99</sup> Policy changes in the roads sector are being addressed through an investment project supported by the Bank. Urban infrastructure is an area where further analysis is proposed.



In the area of **skills mismatches**, the first step would be a study, since the extent of skill gaps and mismatches in the state is unclear at present. The study would include a skills-mapping exercise, to identify particular sectors which would emerge in the near future, so that skill requirements could be projected. This could subsequently be the basis of a skills development strategy to bridge current and future skills shortages and skills mismatches—worked out in consultation with industry, workers, and educators.

## Exploiting the Potential in Emerging Sectors

In the Approach Paper to the Eleventh Plan, the state has itself identified several sectors it wishes to focus on, where it has natural advantages. These include high value-added agriculture (especially horticulture), tourism, and hydropower.

With a view to realization of the full potential from the state's **hydropower** resources, initial reforms could focus on the following dimensions.

- In order to promote *sustainable hydropower development*, it is critical that the state set up an institutional mechanism (including its structure and functions) for monitoring and implementing environment management activities—such as CAT plans, NPV, Compensatory Afforestation, lease value of forest land, development of fisheries, conservation of wildlife, etc.—related to hydropower projects in the state, to ensure that these activities are completed before the projects are commissioned (and are then subject to ongoing monitoring), and that HP's precious natural resources are managed well.
- In order to better *manage hydro revenues*, the state could initiate a strategy study for: (i) the model HP should follow in building up hydropower projects (through state/central/private/joint-venture routes or a combination of these); (ii) analyzing the possible impact on bulk power tariffs from the proposed coal-based ultra mega projects, and the capacity of HP to manage the development

risks associated with the hydro power projects, if they are fully or majority owned by GoHP; and (iii) best utilization of the revenues flowing to GoHP from the hydropower projects to ensure the maximum benefit for the state and for those most affected by the development of projects.

- In order to encourage integrated river basin planning, the state could facilitate a *river basin study* on the Satluj river, and prepare an action plan for time bound implementation, based on the agreed recommendations.
- With a view to implementing the *Electricity Act of 2003*, GoHP could facilitate implementation of open access, separation of the power trading function, and appropriate restructuring of the HPSEB.

In order to improve the performance and sustainability of **agriculture**, GoHP could take the following steps over the next few months.

- GoHP could *review and rationalize the subsidy regime*. Where the state is proposing to focus on organic farming, there is an element of inconsistency in subsidizing consumption of chemical fertilizers and pesticides, and support should instead be aimed at offsetting costs of organic practices, particularly for horticulture and fruit production.
- User charges in irrigation cover less than 2.5 percent of required O&M expenditures, and need to be rationalized. In addition, many irrigation schemes could well be better managed by producers themselves, following successful practices in the state and elsewhere. The state could prepare a *strategy* with an implementation time table and progress indicators, aimed at increasing costs to reach full cost recovery within a designated time period, as well as an action plan for devolving suitable irrigation schemes to beneficiary farmers.

The key constraint in **tourism** appears to be that of connectivity—and addressing this would require



investment resources over the medium term. In the policy arena, the state should activate and empower the Tourism Development Board that has been recently established under the chairmanship of the Chief Minister as a forum for better inter-sectoral coordination and strategic approach for tourism development in the state.

## Improving the Institutional Environment for Growth

In order to promote an institutional environment for development, GoHP must enhance the effectiveness of civil services, strengthen institutions for transparency and accountability, and promote decentralization to improve public service delivery. Short term measures could focus on some of the following areas.

- In order to tackle the key problem of **overstaffing and the wage bill**, GoHP could: (i) enforce a *strict ban on recruitment*, especially for non-regular employees as well as Class IV employees in the regular civil service, and work-charged and part-time workers in IPH, PWD, and HPSEB, and curb regularization; (ii) identify redundant posts by conducting *functional reviews* in major departments, assessing whether current staffing patterns exceed established norms, revising existing norms to take into account technological improvements, and preparing a plan to abolish redundant posts in phases, starting with posts that are both surplus and vacant; (iii) identify posts that could be *outsourced to the private sector* such as the provision of security, gardening, cleaning, and driving services; (iv) *establish an HP Pay Commission* to decouple salary structures from those in Punjab, that would over time chart an independent course for determining the state's salary structure in view of political sensitivities; and (v) implement a *Voluntary Retirement Scheme (VRS)* for government employees who wish to retire, and *compulsory retirement provisions* in the All-India Service Rules to remove inefficient staff from service, especially in organizations like the HRTC and HPSEB.
- In order to improve **administrative efficiency**, GoHP could: (i) strictly enforce the minimum *three-year tenure* as per HP's transfer policy by establishing statutory committees to authorize transfers and postings for senior officers and creating a stability index to ensure that the average tenure of the IAS cadre as a whole does not fall below three years; (ii) review current *functional clustering* at the level of Ministers as well as Secretaries with a view to clustering 'like' Departments; and (iii) at the level of *general transfers* in staff-intensive departments, GoHP could consider the adoption of a system of formal counseling to allocate transfers and postings in a rational and objective fashion, while enforcing quantitative limits on the total numbers of transfers across the state.
- In **e-governance**, priorities for the IT Department— from among the 40-odd projects underway— should be clarified, by focusing on a few flagship projects, and implementation should be sequenced. The focus should be on process re-engineering, rather than just information technology.
- To enhance **transparency and accountability**, the following measures are important: (i) the *suo-motu* provisions of the RTI should be aggressively implemented, especially through posting of *suo-motu* information on the web, and providing departmental websites to those still lacking the same; (ii) efforts should be made to strengthen the Lok Ayukta by amending the *Lok Ayukta Act* to allow for *suo-motu* powers to take action in cases without a formal complaint, by providing qualified legal and other staff to assist him, and by widening the definition of corruption to include grievances arising out of maladministration; and (iii) the weakening of *police capacity* to provide effective law and order services, as reflected in the declining overall conviction rate, should be reversed, by implementing the recent Supreme Court directive to create a State Security Commission to insulate the force from political pressures, and enforcing a minimum tenure of three years for the Director General of Police and senior officers



## Strengthening Human Development and Social Protection Strategies

The **Education Department** could take the lead on the *skills mismatch study* mentioned above. Other measures under consideration to partner with the private sector in the provision of technical education—like using private parties to provide technical and vocational education using the state’s existing educational infrastructure—should be speeded up and implemented. The state should also identify specific steps to improve teacher attendance and accountability—through involvement of communities in the monitoring process.

The **Health Department** could benefit from the *functional review* of staffing described above—with a view to rationalizing postings of specialists in remote areas. A study proposed by GoHP on assessing the *efficacy of mobile vs. static units* could also contribute towards eventually addressing the problem of health service delivery in remote areas.

In the area of **social protection**, the state currently faces issues around record-keeping and technical impact evaluation. GoHP could consider the following measures in this area.

- Carry out *rapid review* of administration and record-keeping in key social protection programmes, in order to develop options for improved performance. Going forward, based on this review, GoHP could develop and approve an Action Plan for improving administration and record-keeping of major social protection programmes (particularly with respect to reporting of outcome indicators).
- Initiate a third party *impact evaluation* of social pensions—the single largest intervention for the poor in the state. This could lead to better design and implementation of the programme in the future.

## Promoting Environmentally Sustainable Development

It would be useful for GoHP to look at measures to **strengthen the Environment Department** and develop capabilities which would help to systematically assess how the state can maximize its natural advantage, and to ensure application of environment norms across sectors.

GoHP could initiate an **institutional and “gap” analysis of the environment sector**, which could then feed into institutional strengthening of environment management in the state, and help in drawing up the proposed Environmental Policy.<sup>100</sup> This could include:

- Assessment of key environmental pressures, with a particular focus on emerging *pollution hotspots, environmentally fragile areas* (including those with high preservation values, such as endangered biodiversity, and high ecosystem functions, such as watersheds), and areas with high *tourism potential*.
- Identification of regulatory, institutional, and policy *gaps* leading to these pressures. This will include assessment of mandates, gaps and overlaps, and also incentives for compliance and enforcement of functions.
- Assessment of *workload and implementation capacity* for the Environment Department, Forest Department, and SPCB, including staffing/skill mix, equipment, and knowledge resource requirements (including contract appointments).
- Strengthening of *compliance and efficiency* by assessing alternative ways of implementation (such as separating the regulatory vs. management vs. implementation roles of the Forest Department), greater use of economic instruments (as recommended by the National Environmental Policy, 2006), allowing contracts with private parties, or line public agencies, recasting the management and implementation functions, and building upon newer initiatives

<sup>100</sup> The Bank’s Environment Unit is happy to assist GoHP with this through technical support under the India Country Environmental Analysis.



such as the Natural Resource Management Society (with systems for clear physical, financial targets and monitoring).

- Assessment of the *effectiveness and ways of improving* Compensatory Afforestation Schemes and use of Net Present Value revenues; strengthening of management practices and guidelines using principles of restoration biology and the global experience with biodiversity offset schemes; establishment of firm timelines for implementation and monitoring progress in both planting and ecosystem restoration.
- Assessment of the *adequacy of the existing range* of policy instruments and feasibility of using new ones that target the systemic and root causes of policy failure.

Based on this analysis, GoHP could develop an **Action Plan** with an implementation timetable, in order to: (i) restructure the Environment Sector as indicated by the analysis; (ii) prepare an overarching Environment Policy as a guiding principle; and (iii) develop a set of key performance indicators to monitor and evaluate progress in implementation.

## B. Political Economy Considerations

Policy suggestions can only be a first step—it is critical to implement the policies that can help the state realize its development goals. GoHP needs to craft an overarching programme for the state to guide reform, identifying the policies—from or beyond those suggested here—that it would like to implement. There is need to build a consensus for change within the state through an effective communications strategy, and get the political leadership to demonstrate their commitment to the proposed programme, motivate agents for reform within the bureaucracy, and garner public support.

It is particularly important to pay close attention to the sequencing and prioritization of reforms, and to move more rapidly on policies which are likely to yield quicker

and visible results. The Report has proposed a menu of measures that can be initiated within the next few months, and GoHP could, based on internal discussions, move forward on those that are considered appropriate and feasible. However, this should not detract focus from other substantive measures recommended in the Report which should be implemented over the longer term to deepen reform.

Additionally, successful reforms have to be context-specific and grounded in local knowledge. The general economic principles behind accelerating growth and improving service delivery—such as a healthy investment climate, sustainable fiscal policy, responsive and transparent institutions, and private sector participation—apply to HP as they do to most other states. However, economic reform principles need to be creatively packaged by policy-makers in order to be sensitive to local constraints and take advantage of local opportunities. In this context, it becomes particularly important to focus on sectors where HP has a comparative advantage, and keep in mind the importance of conserving the environmental resources which can provide further opportunities to the state.

In closing, it should be emphasized that action now is likely to be less costly than action later. Politico-administrative and topographical peculiarities of HP demand a continuing role for the state. However, if the state does not take specific steps towards self-sufficiency, the recent achievements may not be sustainable. In particular, any reduction of privileges as a “special category” state and announcement of Sixth Pay Commission awards could hurt the state’s fiscal situation further; the absence of suitable private sector employment opportunities for the educated population could lead to unfulfilled expectations and add to the fiscal burden for the state as an employer of last resort; and failure to take action against environmental degradation could threaten future growth prospects. It is critical to address these challenges before they start to impact on the state’s successful socio-economic performance.





# Annexes





# Annex 1. New Initiatives and Reforms Proposed by GoHP (Updated June, 2007)

The Economic Report, presented in the earlier chapters, was prepared by the World Bank over September 2006 to December 2006, and largely uses information available at the time of preparation. The Report was presented to GoHP on February 19, 2007. The government was in broad agreement with several recommendations in the Report.

Following discussions with the World Bank after completion of the Report, GoHP has proposed reforms in some important areas. These address critical structural, fiscal, and administrative reforms needed to achieve sustainable and rapid economic growth and inclusive development over the medium term, while protecting the environmental heritage of the state. The key objectives of the government's reform programme in the short to medium term are to fund priority investments through creation of fiscal space and promote environmentally sustainable development—with particular reference to the development of hydropower. GoHP also supports reforms to enhance growth and employment opportunities, and improve governance and public administration.

This Annex describes measures recently announced or adopted by GoHP in order to address the critical challenges facing the state. It should be noted that this is not a description of GoHP's entire programme or vision—but, rather, of the notable new and innovative initiatives since the completion of the Report. GoHP has chosen to prioritize these initiatives in areas where the need for reform is felt to be the greatest.

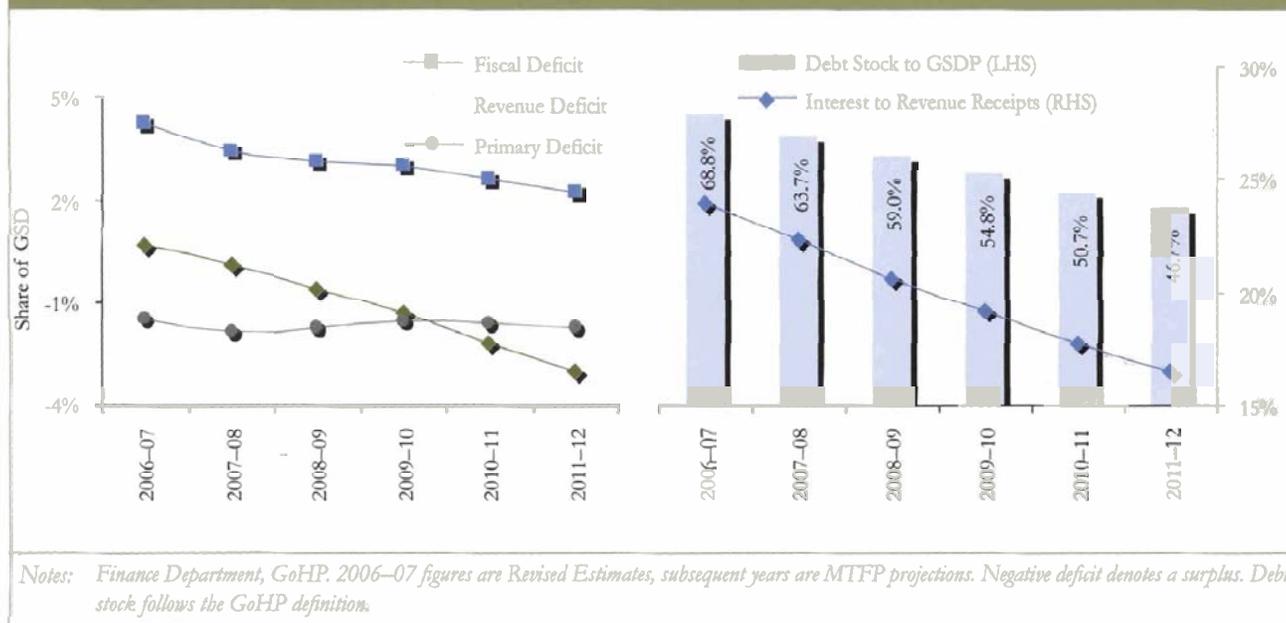
## A. Creating Fiscal Space and Improving Public Financial Management

### Overall Plan for Fiscal Reforms

GoHP's future reform program is underpinned by the MTFP prepared in 2007–08, for 2007–08 to 2011–12. This MTFP has been revised recently, and resolve several issues in the earlier MTFP described in Chapter 2 above. The current MTFP is consistent with the FRBM and TFC recommendations, and targets eliminating GoHP's current deficit in 2008–09, and reducing the ratio of gross fiscal deficit to GSDP from 4.3 percent in 2006–07 to 2.2 percent by 2011–12 (Figure A1.1). It projects improvement in expenditure composition and strengthening of own tax revenue—reflecting fiscal reforms. By 2011–12, about 5 percentage points will be shaved off the 2005–06 salary to total expenditure ratio of 35 percent. There will be reallocation to non-wage O&M and capital outlay, which will increase by 5 percentage points and 7 percentage points respectively over 2006–07 (RE). Own tax revenue is projected to rise by 1.3 percentage points of GSDP over 2006–07 (RE). The state projects debt to GSDP ratio to decline to about 47 percent by 2011–12 from 74 percent in 2005–06.

The targeted debt reduction is achievable if the state stays on the projected fiscal path under the MTFP. However, the debt trajectory is sensitive to fiscal shocks, and will require the state to maintain a strong fiscal

Figure A1.1: Improving Deficits and Declining Debt under Revised MTFP



correction path over the medium term to achieve debt sustainability (Figure A1.2). Stress tests demonstrate that future uncertainty or shocks like decline in central transfers or lower growth rates than those assumed under the MTFP could derail the projected debt reduction trajectory. This shows the need for continued maintenance of fiscally sustainable policies over the medium term, as well as the importance of robust and sustained fiscal correction to counter future uncertainties that can upset the trajectory of debt reduction.<sup>101</sup> In order to maintain the projected fiscal correction path, GoHP has announced various measures which are described below.

## Reforms to Enhance Tax Revenues

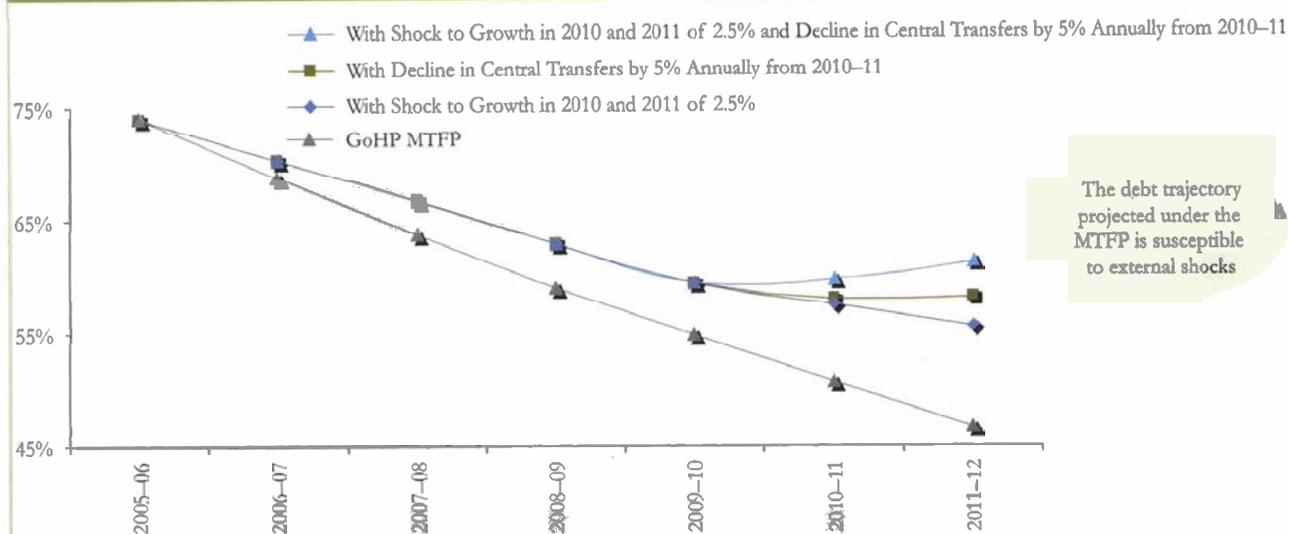
To improve tax revenues, GoHP has announced several encouraging measures in its 2007-08 budget to raise its

own tax revenue from 5.9 percent of GSDP in 2005-06 to 6.5 percent by 2011-12. If successful, the state's dependence on central government grant transfers will decline from 15.2 percent of GSDP in 2005-06 to 11.8 percent by 2011-12. The measures will correspondingly lead to improvement in own revenue effort from 8.6 percent of GSDP in 2005-06 to 9.1 percent of GSDP by 2011-12.

- For the *motor vehicle tax regime*, GoHP proposes to increase Motor Vehicles token tax rates to target an additional growth of at least 6 percent in motor vehicles tax take over 2006-07 (RE). To avoid congestion and pollution, a higher token tax has been proposed for vehicles over 15 years. These measures should yield an Additional Resource Mobilization of about Rs. 6 crores, over and above natural buoyancy. Additionally, the Transport Department shall initiate studies to examine how to improve

<sup>101</sup> See Annex 5 for details.

Figure A1.2: Debt as a Share of GSDP under Various Scenarios



Notes: See Annex 5 for details.

motor vehicle taxes, including the use of ad valorem taxes for all new vehicles.<sup>102</sup> GoHP has also liberalized the licensing rules for private bus operators effective financial year 2007-08, and that should see an increase in permit and registration fees, the annual token tax, and the special road tax.

- To plug leakages in the collection of *luxury tax* by hotel owners, the luxury tax will be based on minimum occupancy of beds as opposed to the present regime of a flat 10 percent of hotel room rent.
- GoHP has introduced a new *license fee system* to vend liquor based on minimum guaranteed off-take for different kinds of liquor. The system, as presently structured, has specific excise duties on liquor and licensing to vend liquor classified in eight categories, with sub-categories.

- The introduction of *VAT* in 2005 raised growth in sales tax revenue by 34 percent in 2005-06—but this is projected to grow by a slower rate of 7 percent in 2006-07 (RE). Although VAT is the main own tax source, gains from this may dry out following two years of implementation if its administration is not strengthened. The yield from this tax has to be raised at least to the national average of 3.7 percent of GDP. As a first step, GoHP is undertaking computerization of VAT administration. Furthermore, GoHP is considering an evaluation that could include value chain analysis, VAT assessment, system of refunds, use of nationally harmonized definition of goods, fraud risk analysis, VAT threshold limit, etc. The results of the evaluation will be used to further strengthen VAT administration.
- Studies shall also be initiated to explore further areas for increasing tax buoyancies, including

<sup>102</sup> Non-transport vehicles are subject to one time tax, while transport vehicles are subject to an annual tax. In addition, HP levies a special road tax on transport vehicles. The current level of the one time tax is 2 percent on the price of personal vehicles such as cars and 1.5-3 percent on the price of two wheelers. The one time tax is considerably lower than in other states where it could range between 6 percent and 8 percent of the price of the vehicle. Transport vehicles are charged an annual specific tax depending on the nature of the vehicle.



folding the *electricity duty* into the VAT. GoHP currently has an electricity duty at the flat rate of 6 paise per unit consumed in bulk use and 33 paise per unit on consumption by industries, as last revised in the 2005–06 budget. The tax take from this source has been uneven over the years and constituted below 4 percent of tax revenue in 2005–06.

- The *stamp duty* rate for registration of land sale transactions is proposed to be reduced from 8 percent to 5 percent, so as to check evasion and the undervaluing of property transactions. GoHP has already reduced stamp duty from 12 percent to 8 percent in April 2005. As a further measure to strengthen administration, GoHP will introduce franking machines to plug leakages in stamp duty revenue. In HP, at present rates, stamp and registration duties amount to a potential tenth of property value, higher than in most other states.<sup>103</sup> Stamp duty reform is, therefore, a significant measure, and is expected to increase registered property transactions, create a more active land market, and make the state more attractive for investment.

## Reforms to Enhance Non-Tax Revenues

Since HP is a small state, its tax base is limited. Accordingly, non-tax revenue needs to be expanded, with the major source identified as the state's *natural hydropower potential* that will make the state a net exporter of electricity. It is estimated that revenues from the sale of royalty power and/or a share of the power generated proportional to equity invested by GoHP in hydro projects with other partners—e.g., GoI in the case of Satluj Jal Vidyut Nigam Limited (SJVN)—together with dividends, could be more than 37 percent of HP's current level of own revenue receipts and more than double the current level of own non-tax revenues by

2012–13. However, efforts need to be broad based beyond hydropower resources to raise non-tax revenues in order to help make critical services provided by GoHP self sustaining. There is scope for raising royalty from *user charges* periodically, in particular. However, rationalization of user charges is politically challenging which makes the pace and magnitude of revision more difficult, and this has to be calibrated. A rational institutional mechanism that can periodically decide on appropriate user charges is required.

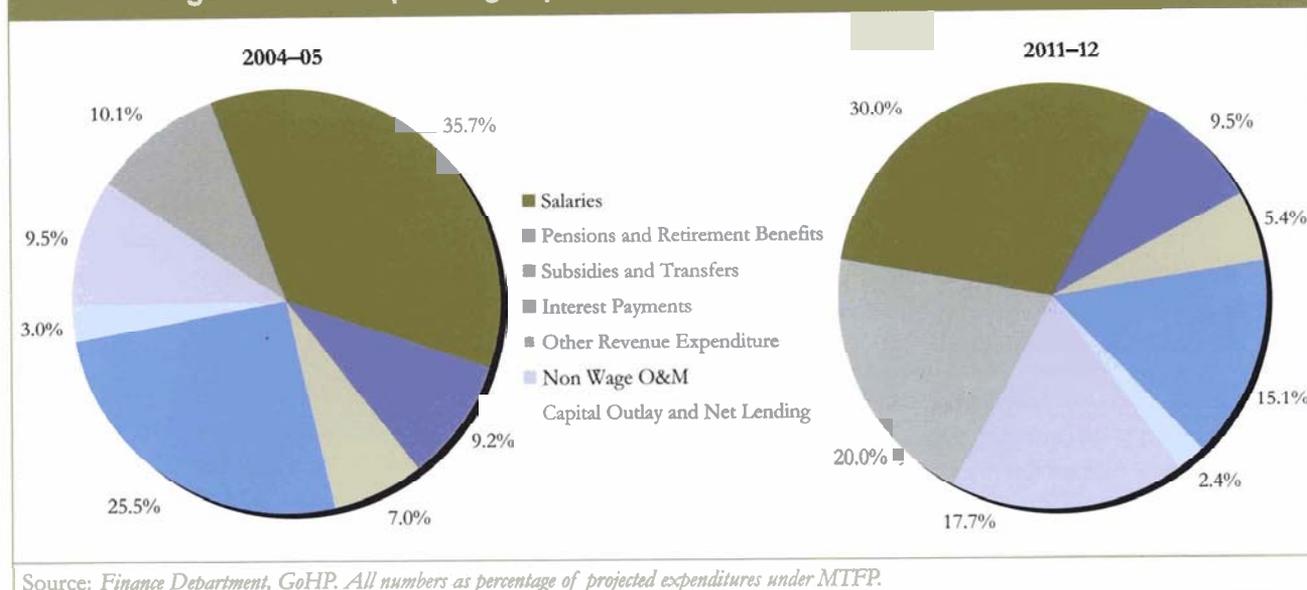
As a first step to improving cost recovery, GoHP has indicated that an administrative *review of user charges* will form the basis for rationalizing user charges. Eventually, an institutional mechanism will be set up—to regularly review user charges, reduce implicit subsidies, and improve sustainable financing of O&M of public investment. GoHP also plans to *reconstitute Rogi Kalyan Samitis*—which were abolished in 2003—and provide them autonomy in deciding on user charges.

GoHP is working to address the fiscal burden arising from the *gap between O&M expenses in Irrigation and Public Health and the user charges collected*. As discussed in Chapter 4, user charges fund about 2.5 percent of O&M expenses incurred by the government. GoHP has already developed guidelines for devolving schemes to beneficiary groups. GoHP has initiated pilots that will be scaled up over time. As of March 31, 2007, operations of 292 Water Supply Schemes and 17 Minor Irrigation Schemes had been transferred to GPs and users respectively, on a pilot basis. In addition, the state has already announced a participatory strategy involving Water User Associations and Gram Panchayats (GPs) to participate in planning and execution of irrigation and drinking water schemes respectively. This will be practised for all new projects wherein the government provides technical and one-time financial support to the GPs or beneficiaries to develop their own water resources.

<sup>103</sup> In addition to the 8 percent stamp duty, registration fee under the Indian Registration Act, 1908, as applicable to HP, at the rate of 2 percent on the value of consideration, subject to a maximum of Rs. 25, 000 is also levied. Most states levy only 1 percent registration fee.



Figure A1.3: Improving Expenditure Composition under GoHP MTFP



## Targeted Improvements in Expenditure Composition

Simultaneously, the government appreciates the need to improve expenditure composition towards capital outlay and critical non-wage O&M. As a first step, the MTFP has committed that GoHP will: (i) contain share of salary expenditure to total expenditure to 30 percent by 2011–12; (ii) reduce interest expenditure to revenue receipts to 17 percent by 2011–12; and (iii) increase non-wage O&M and capital outlay by at least 4 percentage points and 8 percentage points of total expenditure by 2011–12 (Figure A1.3). Achievement of these targets will be critically dependent on the reforms implemented. GoHP has announced several reform measures to create fiscal space and improve expenditure effectiveness. These actions are projected to result in a decline in the expenditure to GSDP ratio from 28.2 percent in 2006–07 (RE) to 26.6 percent in 2009–10.

*Subsidies and transfers* account for about 7 percent of total expenditure, up from 5 percent in 2003–04. GoHP's subsidy to the Himachal Pradesh Electricity Board (HPSEB) was Rs. 2.45 billion in 2006–07 (RE)—which is relatively small compared to other states.<sup>104</sup> GoHP has reduced the power subsidy to Rs. 1.5 billion in the 2007–08 budget, and will strive to contain the level of the subsidy.

- *Pensions* are an increasing fiscal burden, having risen from about 8 percent of expenditure in 2002–03 to over 9 percent at present. In August 2006, the state introduced a Contributory Pension scheme for new employees joining service after May 15, 2003, and it follows the GoI pattern of contributions.<sup>105</sup> However, the impact of the new pension scheme will be felt over the longer term, and, till then, the state will have to contend with pension expenditure under the Defined Benefit scheme

<sup>104</sup> The power subsidy essentially finances the revenue loss to the HP State Electricity Board on account of the difference in the tariff recommended by the Himachal Pradesh Electricity Regulatory Commission and the implemented tariff. The scale of the subsidy is small in HP as compared to other states (e.g. Andhra Pradesh and Tamil Nadu) and there are no issues of free power to contend with.

<sup>105</sup> The employee contributes 10 percent of Basic Pay and Dearness Allowance towards his pension benefits and the state matches the contribution.



for employees hired prior to May 15, 2003. GoHP has announced the creation of a fund for financing Defined Benefit pension scheme with an initial corpus of Rs. 0.5 billion that will be enhanced over time. GoHP also plans to undertake pension liability and cash flow projections with respect to civil service with a view to medium term reforms.<sup>106</sup>

- In 2006–07, the state had initiated a system of *performance-based* budgeting, which will be actively pursued and implemented.
- GoHP plans to expand performance budgeting by initiating departmental *Medium Term Expenditure Frameworks* in a few key departments, such as Education, Health, Public Works, and Irrigation and Public Health.
- GoHP proposes to develop *maintenance plans* for fixed assets such as roads, buildings, and equipment for funding purposes.
- GoHP is considering a permanent internal *institutional mechanism* to undertake rolling annual reviews to identify unproductive programmes, and rationalize and improve efficiency of existing programmes.

## Management of Debt and Contingent Liabilities

GoHP has been classified as a *debt stressed state* by GoI.<sup>107</sup> Over the period 2007–08 to 2011–12, GoHP proposes to replace Rs. 15.5 billion of high cost debt with coupon rates of 10 percent and above. Debt that carries coupon rates 10 percent and above constituted about 18 percent of outstanding debt stock at the end of March 31, 2007. Approximately 40 percent of the debt will be repaid between 2007–08 and 2011–12. As GoHP's fiscal situation improves, its interest expenditure to revenue

receipts ratio will also decrease from 24 percent in 2005–06 to 17 percent in 2011–12.

HP has 23 *Public Sector Enterprises* (PSEs) that employ close to 50,000 people. Importantly from a resource flow perspective, however, the annual support to PSEs by way of direct subsidies is not too high. GoHP has kept annual subsidies to these enterprises at a relatively low level of Rs. 0.4 billion in 2006–07, down from Rs. 0.48 billion in 2005–06. Much of this is given to Himachal Road Transport Corporation (HRTC) on account of the state's social responsibility of providing public transport services on unviable routes. On the other hand, contingent liabilities in the form of outstanding guaranteed borrowings by state-owned PSEs is high—at about Rs. 35.5 billion or about 14 percent of GSDP as on March 31, 2006. The government also carries significant fiscal risks from the accumulated losses incurred by PSEs. As of March 2006, the total past accumulated losses of these enterprises was about Rs. 9 billion or 3.5 percent of GSDP. The HPSEB and HRTC and are the largest, accounting for nearly 80 percent of the employees and 70 percent of the accumulated losses.

GoHP has proposed several reforms to lower off-budget borrowings and contingent liabilities. The 2007–08 budget has announced that *risk-weighted state guarantees* for loans will be capped at existing levels. GoHP will cap guarantees at 40 percent of the previous year's revenue receipts by the next financial year. This will help minimize exposure to poorly performing state owned enterprises and boards, while making the award of guarantees strategic in furtherance of development objectives. Off-budget borrowing is to be contained, and the state has already consolidated Rs. 27.6 billion of its off-budget borrowings in its books. Moreover, GoHP presently reports guarantees on an equal

<sup>106</sup> Projections will be initiated for Statutory Boards, Corporations, Universities and Aided Institutions, and Local Bodies and the DC scheme is proposed to be extended to cover new pensionable staff in these agencies.

<sup>107</sup> A state is classified as "debt stressed" by GoI if its interest payment to revenue receipt ratio is equal to or greater than 20 percent.



weighted basis—but will begin reporting risk-weighted guarantees as required under the FRBM. While these PSEs as of today are not imposing a huge annual cash subsidy burden on GoHP, the loans extended to some corporations and guarantees given to others may result in a future fiscal liability. In the medium term, GoHP plans to put in place a set of formal rules to govern eligibility of PSEs, cooperatives, and statutory boards for government guarantee.

## Improving Public Financial Management

Despite several achievements described briefly above, some key areas need strengthening for the state's **public financial management system** to assist expenditure effectiveness, and support GoHP's medium term fiscal and governance program. The need for reform is particularly evident in the area of budget execution procedures, including weaknesses in internal controls. It is necessary to complete the ongoing computerization of treasury systems, create an internal audit system, and have more effective legislative oversight and timely follow up on audit observations. GoHP has outlined an agenda for further strengthening financial management and procurement and prioritized the following actions from the year 2007–08 onwards: (i) *modernize the Himachal Pradesh Financial Rules, 1971*, in line with the General Financial Rules (GFR), 2005, of GoI, to strengthen internal controls; (ii) reinforce the *responsibility and accountability of Heads of Department (HoD)* to ensure more effective utilization of resources and strengthen internal controls; (iii) conduct a *Public Financial Management and Accountability Assessment* to review PFM arrangements including in the PSEs, starting with two largest PSEs; (iv) complete *treasury computerization* and roll out coverage to the sub-district level; (v) constitute a working group to work out an *internal audit function* in terms of scope, coverage, and focus, with a view to moving towards a 'risk based' audit approach as opposed to a transactions based audit approach, and streamline the audit function in Urban Local Bodies

(ULBs); and (vi) *reduce backlog* of Utilization Certificates and audit of ULBs, and (viii) create a database of serious audit observations, to monitor and improve the responsiveness.

As regards modernization of **public procurement systems**, the challenge is to integrate procurement into a well defined PFM system. GoHP proposes to follow such an approach that will focus on integrating procurement with planning, budgeting, accounting, and auditing. The reform will be overseen by the Finance Department, and will work towards instituting a modern procurement law to guide procurement activities in government and conducting an assessment for e-procurement.

## B. Promoting Key Sectors for Growth, Employment, and Revenue Mobilization

### Tapping Hydropower Resources Efficiently and Sustainably

GoHP appreciates that the development of hydropower should be in consonance with environmental safeguards. Implementation of most of the environment management activities falls within the domain of the state and, HP is taking steps to strengthen its institutional structures for the planning, implementation, and monitoring of environmental management activities. The state is designing an accountability mechanism for preparation and implementation of **CAT Plans**. It is also taking steps to accelerate the implementation of the CAT plans for the ongoing hydropower projects—in the short term, the focus will be on identifying 3–4 critical items from the CAT plans of ongoing large hydropower projects and demonstrating implementation of the same. In the medium to long term, the focus would be on scaling up the full implementation of CAT plans across ongoing hydropower projects and ensuring their



implementation at the earliest, and for the new projects, in parallel with the project implementation schedule. One of the approaches that the state is considering is outsourcing implementation of some of the activities under the CAT plan to either the project implementing agency or other contractors. In parallel, the state is planning to undertake an assessment of the skill and capacity gaps existing in the different state agencies for undertaking the environmental management activities, and will then prepare a plan for building up capacity for implementation and supervision. In addition, HP is beginning to focus on incorporating the **river-basin approach** while preparing such plans. For a start, GoHP has facilitated the initiation of a study for the Satluj Basin for the optimal and integrated development of power.

As described in Chapter 4, HP has been following a **mixed model** of development of the hydropower resources. Recently, however, following the establishment of the Himachal Power Corporation, it has been proposed that a number of new projects that had been either earlier allocated or are still unallocated be transferred to this new entity for development. This new approach can have significant challenges for the state. GoHP proposes to strategically evaluate the risks and benefits involved in following this model, in comparison with the corresponding risks and benefits from the alternative models. In addition, GoHP also plans to analyze best management of revenues flowing to state from the hydropower projects, to ensure the maximum benefit for the state and for those most affected by the development—including suggesting alternative ways for benefit sharing with the communities.

The **internal efficiency of HPSEB**—which had been suffering financial losses until FY06, but has now started to show a cash surplus driven mainly by the significant increase in revenue from inter-state sales—remains an issue. Under the Electricity Act (2003), states were to restructure their state electricity boards by segregating the transmission function from the power trading function. With a view towards implementing

the Electricity Act of 2003, GoHP/HPSEB proposes to prepare an implementation plan for enhancing the effectiveness of operations of HPSEB under the Electricity Act 2003—and begin implementation of the plan.

## Unlocking the Potential in the High Value Tourism Sector

Despite GoHP's stated commitment to tourism development, an inter-departmental consensus on its importance appears to be absent. The state's current **Tourism Policy** lacks clear funding provisions, and is behind targets in terms of implementation deadlines, as discussed in Chapter 4. Accordingly, GoHP will support the update of the existing Tourism Policy. This will include: (i) a view of the future within the context of Indian tourism, recognizing that tourism and economic development are inseparable and mutually supportive; (ii) a macro-level perspective plan for tourism development of HP, so as to guide future development in a strategic, scientific, sustainable, and professional manner, while keeping within the defined vision; (iii) a micro-level destination development master plan, with a 1–5 year perspective, for the focused development of the specific areas/sites/sub-regions/themes identified for tourism development; (iv) well defined mechanisms for financing this vision through public, private and joint sectors; and (v) clear responsibilities and accountability for implementation.

GoHP seeks to **strengthen institutions** for tourism development. In order to develop and implement this vision, the institutional mechanism—including inter-departmental coordination—has to be improved. The HPTDB is an apex body that could take the institutional lead—but it must be activated, with clear mandates and regularized meetings. The HPTDB must lead in facilitating a political consensus amongst all constituencies about the importance of tourism, and clearly communicate to all the stakeholders that tourism



is a priority industry. The Executive Body of the HPTDB is supposed to have over 100 members, which makes it unwieldy. The organization, composition, and mandate of the HPTDB will be evaluated by GoHP, and changes introduced as appropriate in subsequent years if required. GoHP also plans to create an empowered Single Window mechanism under the TDB for facilitating approvals for tourism projects, requiring inter-departmental coordination. If necessary, GoHP will hire professionals to work with the government on a longer term basis. GoHP also plans to involve and consult with civil society groups in developing tourism—especially in its plan to certify and classify tourist facilities, and organize specialized tourist events like annual fairs, etc.

The state proposes direct measures to **involve the private sector**. The state runs the HP Tourism Development Corporation (HPTDC)—and while lack of funds prevent upgradation of HPTDC facilities, the private sector also cannot operate these state-owned properties in a more profitable and professional manner. Properties that belong to HPTDC, if privatized, could send the right signals to investors. It is likely that good tourism properties owned by the government could earn much more revenues for GoHP, apart from attracting the high end traveler, if run professionally by a good hotel chain. GoHP has already tendered for Expressions of Interest for the development of seven properties, broadly suggesting usage—like golf courses, health facilities, hotels, etc.—in conformity with GoHP’s priorities. Short listing is in process, and bids are likely to be approved this calendar year.

In order to **promote connectivity**, GoHP is also planning to involve the private sector in the construction of three ropeways: Dharamshala-Triund, Manali-Rohtag-Solan, and Kullu-Bijli Mahadev. The bid process for this will be initiated shortly. Over the medium term, the state plans to upgrade Kangra and Buntur airports to allow for larger aircraft carriers, as well as develop helipads and helicopter connectivity.

## C. Promoting the Institutional Framework for Environmentally Sustainable Development

GoHP recognizes the need to **improve institutions to manage environmental assets**, as described in Chapter 7. GoHP has committed to improving environmental management, particularly by: (i) promoting *inter-departmental coordination* to ensure convergence of environmental objectives and minimize intersectoral conflicts; (ii) strengthening the *Environment Department*, which currently has insufficient capacity and powers, in order to capitalize on the state’s comparative advantages and use environmental resources as growth drivers; and (iii) preparing an *Environment Master Plan* supporting development goals, and providing a holistic view of the growth-generating potential of natural resources, as well as the limits and carrying capacity of key resources.

Recognizing the importance of environment, GoHP, in its Budget announcement, has proposed to form a **Department of Environment and Pollution Control**, as per terms of reference issued by the Ministry of Environment of Forestry in GoI. A comprehensive Government Order has already been notified by GoHP on April 13, 2007, providing details for the formation of the department itself, its staff and equipment composition, and functions for each of the subset departments: Science and Technology, Biotechnology, and Environment and Pollution Control.

An urgent need has been noted for conducting a **capacity assessment** for the new Department of Environment and Pollution Control. The assessment would review staffing/skill mix, equipment, knowledge and resource requirements, as well as identify functions to be performed by the Department and those to be outsourced. It has been further emphasized by GoHP that the state’s extremely fragile Himalayan ecosystems warrant a strong research and development capacity in priority areas such as adaptation strategies



for glacial melts due to global warming; preservation of pasture lands and wetlands (Ramsar sites); river basin issues impacting environment flows, aquatic life and impacts on livelihoods. GoHP plans to mainstream environment management within sectoral agencies by preparing sectoral guidelines to strengthen environment management in sectors with high vulnerabilities. This will be initiated with a particular focus on the needs of the hydropower sector.

With a long term perspective in mind, GoHP has indicated its intention to prepare an **Environment Master Plan** for the state to foster inter-departmental coordination and include environmental considerations as key planning tools. This includes identifying execution, accountability, monitoring, and enforcement procedures, and roles for other departments such as Transport, Forestry, Tourism, Hydropower, Industry, Urban Development, Town and Country Planning, and Public Works—to be coordinated by the Environment Department. The components of the Environment Master Plan would include detailed resource inventory covering all environment parameters; trend analysis of environment degradation; vulnerability assessment to establish zones and appropriate development criteria to guide development and optimize resource utilization. Once prepared, its implementation would be piloted, beginning with fragile areas and gradually scaling up to state level.

In order to build up towards the Environment Master Plan, GoHP will first initiate a “**gap analysis**” of the sector. This would include: (i) assessment of environmental pressures in various areas in the state; (ii) identification of regulatory, institutional, and policy gaps leading to these pressures; (iii) assessment of workload and implementation capacity for the Environment Department, Forest Department, and the State Pollution Control Board; (iv) strengthening of compliance and efficiency by assessing alternative ways of implementation of development projects; and (v) assessment of adequacy of the existing range of policy instruments and feasibility of using new ones that target the systemic and root causes of policy failure.

In addition, GoHP is keen on strengthening **community involvement mechanisms**, to enhance environment performance and accountability, and improve regulatory compliance. Since GoHP has already established Local Area Development Committees in each district, it has been proposed that pilot “community environment monitoring mechanisms” would be initiated through these Committees. In addition, grievance redressal mechanisms will be established by project proponents to increase their environment responsibility and public accountability.

In the context of GoHP’s specific needs of balancing green cover and maintaining the “health” of forests, the need for further research in the area of **environmental restoration and regeneration** has been recognized by GoHP. GoHP will work on preparation of guidelines to strengthen the Compensatory Afforestation programs using scientific criteria (e.g. biodiversity offsets, restoration biology) in the short term.

## D. Improving the General Business Environment for Private Sector Participation

Given that one of the key constraints to private sector development as well as productive employment for educated youth is the **skills mismatch** discussed in Chapter 3, GoHP is seeking to assess and project the skill needs of the secondary and tertiary sectors; better match the provision of technical and vocational training opportunities to market opportunities; and improve the general quality of education with a view to increasing employability. The state proposes to undertake a study on skills mismatches and shortages in HP. This will be an important step, since the extent of skill gaps and mismatches in the state is unclear at present. This constrains evidence-based policy reforms. The study would include a skills-mapping exercise, to identify particular sectors which would emerge in the near future, so that skill requirements could be projected.



Based on this, the state plans to come up with a skills development strategy to bridge current and future skills shortages and skills mismatches—worked out in consultation with industry, workers, and educators. It should be noted that it is not proposed that GoHP take the lead on skill development—but that the study provides grounding for policy-based reform, including on private sector involvement.

GoHP is also working towards **improving transport facilities to raise connectivity**—which is another major bottleneck faced by the private sector. As part of a strategy to make available public transport to rural areas, GoHP has announced an automatic licensing scheme for all investment applications, where at least 60 percent of the bus route is for rural roads. To make full use of the high investment made in roads construction, the licensing regime will be liberalised to grant more permits to the private sector for plying of buses. This new policy is a “win-win” on many accounts. There shall be more direct and indirect employment avenues for the unemployed youth. Through better transport opportunities, the state economy shall benefit substantially, especially in sectors such as agriculture, horticulture, and tourism. The state’s tax revenues will also gain in terms of enhanced consumption of diesel, spare parts usage and higher collection of road tax. The role of HRTC will continue to remain important, especially for the interior and far flung areas of HP.

GoHP also plans to step up **infrastructure development** in industrial areas. Though the Baddi-Barotiwala-Nalagarh Development Authority (BBNDA) has been set up to oversee infrastructure development in the area, there are issues of funding and coordination. The government will promote measures to synergize efforts under the BBNDA, the Industries Department, and other relevant agencies—to avoid duplication in planning and implementation of industrial area development of BBN area. A proposal for development of worker housing in the BBN area, based on public private partnerships, will also be supported. A proposal to enact the Industrial Area Development (IADA) Act

to facilitate planned industrial infrastructure development through the creation of industrial area authorities in priority locations is expected to be enacted. Measures would be taken to strengthen the BBNDA and other IADAs through additional funding during the next few years.

GoHP will undertake a study to evaluate the effectiveness of **business facilitation measures** at the state and district level. Measures like the single window facility have been in operation in the state for several years—and GoHP would like to assess its effectiveness and identify remaining bottlenecks. Recommendations from the study will be implemented in future.

## E. Strengthening Governance and Public Administration

Transfers are an important issue, and GoHP supports increasing **tenurial stability**. As described in Chapter 5, the average tenure (in their current posts) of Principal Secretaries and Secretaries in HP is currently a mere 14 months; tenures for Deputy Commissioners are marginally better, at 17 months, but still well below the three-year minimum tenure set by HP’s transfer policy. Given the high turnover among senior staff, GoHP is seeking to improve the tenure and stability of civil servants to promote effective implementation of programmes by enforcing the average tenure of a minimum of three years, consistent with HP’s transfer policy, while discouraging politicization of transfers and recruitment. GoHP also plans to contain transfers across government at 3 percent of the actual working strength of cadres per year. A Committee on Minimum Tenures is to be established and GoI’s proposal on minimum tenures for Indian Administrative Service posts is to be accepted. Furthermore, mid-year transfers in Education are to be banned.

Improving administrative efficiency through better **file management** is a policy priority. While GoHP



has introduced a computerized file monitoring system in 2004, very few Departments are actually using the system to reduce delays and cut pendency. Section officers in particular are not well trained in the use of computers. The use of the single-file system across government is limited, with only Rural Development and Panchayati Raj making use of that at present. GoHP will focus on the use of change management tools to better equip staff for the wider use of e-governance in the Secretariat. The single-file system will be extended to selected major departments. GoHP will also issue a Government Order requiring use of REFNIC—which is a file tracking software—by departments for all file management and tracking functions in Secretariat.

GoHP needs to strengthen **police capacity**. Despite a good law and order situation, the overall conviction rate for all crimes (including, but not limited to, corruption cases) under the Indian Penal Code (IPC) and Special Local Laws (SLL) has fallen in the last decade. Measures to reverse the weakening of police capacity to provide effective law and order services, reflected in the declining overall conviction rate, will include implementing the recent Supreme Court directive to create a State Security Commission to insulate the force from political pressures. HP has also notified GoI rules designed to

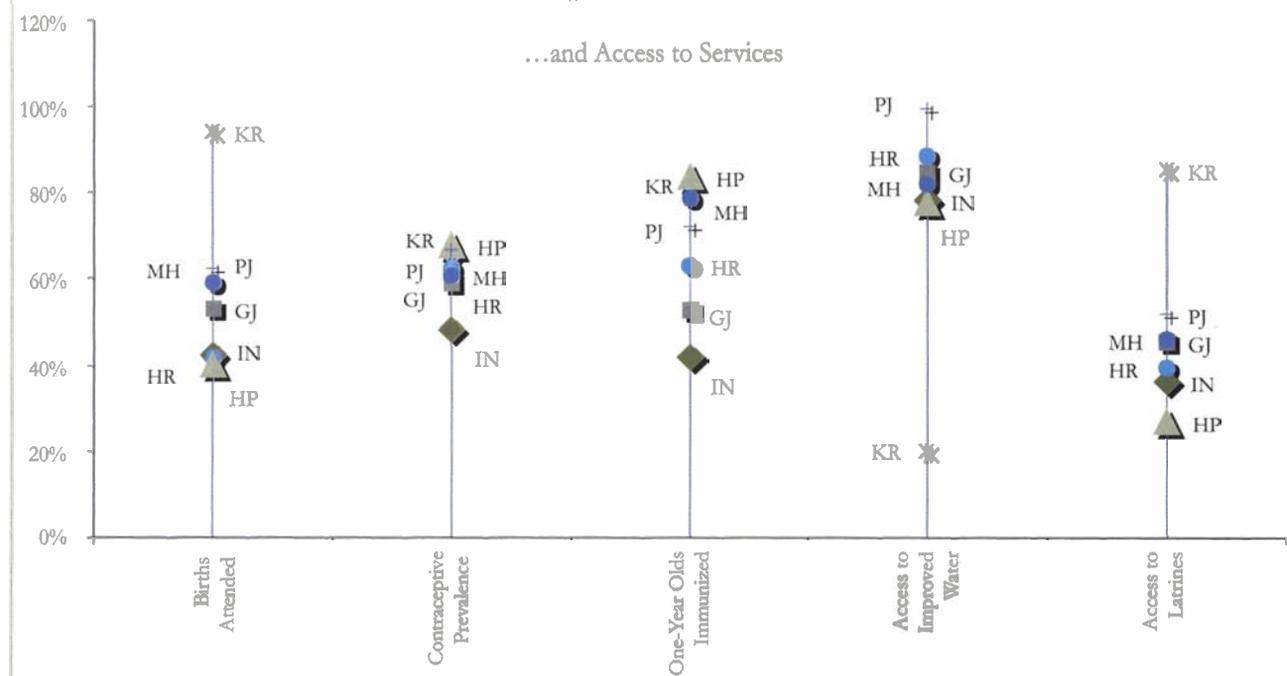
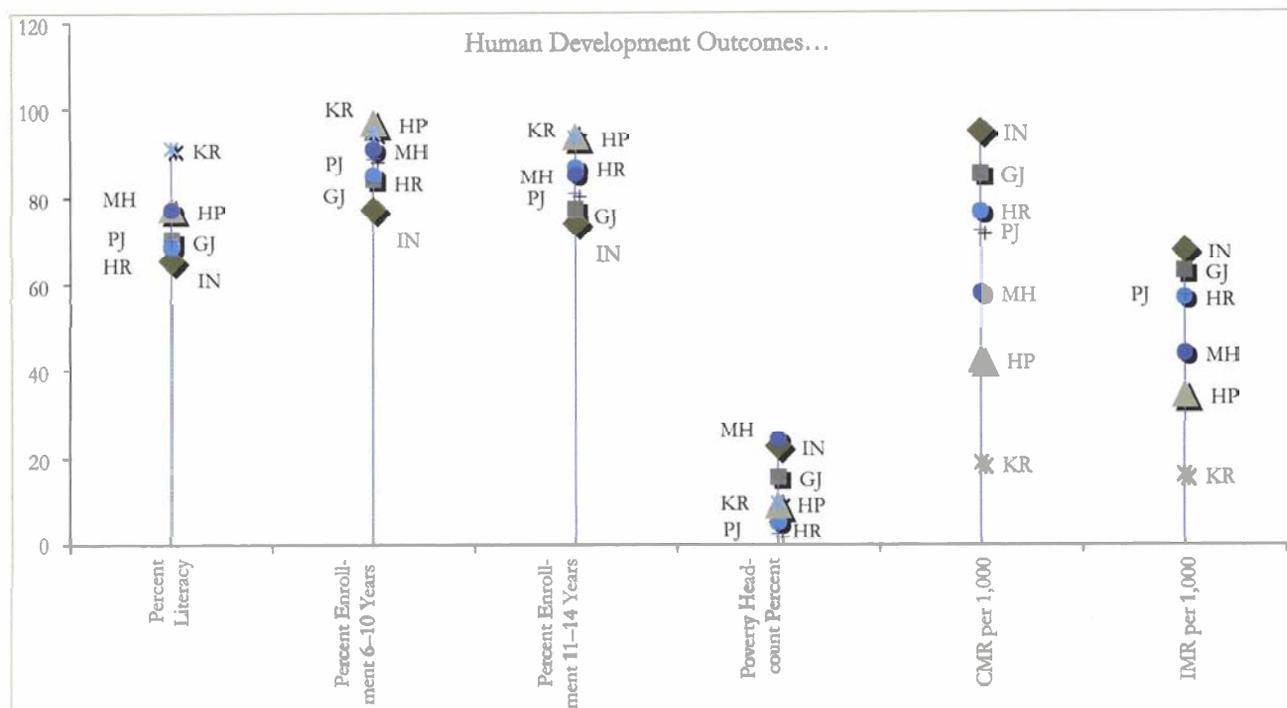
ensure stable tenures for the Director General of Police and other senior officers.

**E-governance** has enormous potential in HP as a tool for simplifying transactions and making it easier for citizens to access government services. GoHP plans to implement land records computerization in 88 Tehsils and Integrated Service Center kiosks in all Tehsils in Shimla District, with at least seven services during the coming year. This will be scaled up to other districts during subsequent years, along with business process re-engineering initiatives as necessary.

Among **other measures to improve public administration**, the *Right to Information Act* will be more aggressively implemented. All state Departments are being encouraged to post all the required information under the RTI Act on their respective websites, so that the common citizen can access all relevant information pertaining to departmental schemes. GoHP plans to experiment with an *outsourcing policy* in some key departments—including functions like sanitation work of hospitals and urban local bodies. Furthermore, GoHP proposes to undertake *functional reviews* of departments with a view to improve government efficiency.



# Annex 2. Some Human Development Outcome and Access Indicators, HP and Other States



Note: All data from National Sample Survey (1999-00) or National Family Health Survey (1998-99). States represented are MH=Maharashtra; KR=Kerala, GJ=Gujarat; HR=Haryana; PJ=Punjab; HP=Himachal Pradesh, and IN=India Average.



# Annex 3. Technical Note on Estimation of Vulnerability

## Defining Vulnerability

Poverty and vulnerability are closely related but distinct concepts. Poverty is the actual observed state of the household falling below a specified threshold with respect to a specified welfare measure. Vulnerability, on the other hand, is the prior probability of the household being poor. In other words, poverty is the *ex post* realization of a state while the latter is the *ex ante* probability of a household being in that state. Households vary in their exposure to shocks and in their ability to cope with these shocks. Consequently, some households may be more vulnerable than others. Thus, it is important to examine vulnerability arising due to household characteristics and/or shocks that make households more likely to remain in poverty or to fall into poverty in the future.

In this Note, we adopt the approach that vulnerability is “the likelihood that at a given time in the future, an individual will have a level of welfare below some norm or benchmark”. This approach develops a model to predict realized welfare, measured as consumption in this specific case, at a point in the future using cross-sectional data, and the probability of an individual household falling below the predicted welfare level (see Chaudhuri 2000). Two attractions of this approach are: (i) the measures of aggregate vulnerability are analogous to poverty incidence and are thus easy to interpret and apply to policy; and (ii) data availability.

The basic intuition behind this methodology is essentially to understand the household’s random consumption generating process and hence, the probability of household consumption falling below a specified threshold. In the absence of panel data with observed consumption distributions over time, a consumption

model is estimated using cross-sectional data and the predictions from this model are used to generate the distribution of expected consumption and the predicted probability of being poor in the future. Households with probability of future poverty below an arbitrarily chosen vulnerability threshold, analogous to the poverty line, are classified as vulnerable to expected poverty. While it is acknowledged that vulnerability is essentially a forward-looking concept so that cross-sectional data can provide some insight only at the cost of stringent assumptions, it is equally important to make an attempt, in the absence of panel data, to highlight the need to focus on the volatility of consumption and the movement of households into and out of poverty.

## Key Steps in Estimation of Vulnerability

Empirically, the first step is to estimate a reduced form consumption model as follows:

$$\ln C_h = \mathbf{X}_h' \boldsymbol{\beta} + e_h \quad (1)$$

where  $C_h$  is the per capita household consumption expenditure,  $\mathbf{X}_h$  is a  $(k \times 1)$  vector of household characteristics (including household demographics, main economic activity, endowments of labor and land, etc.),  $\boldsymbol{\beta}$  is a  $(k \times 1)$  vector of unknown parameters that describe the state of the economy and  $e_h$  is the normally distributed error term  $N(0, \sigma_{e,h}^2)$ . This error term captures the idiosyncratic shocks that result in different levels of per capita consumption for otherwise observationally identical households. The model allows for the cross-sectional variance of the error (and hence of log consumption) to vary with household characteristics as follows:

$$\sigma_{e,h} = \mathbf{X}_h' \boldsymbol{\theta} + u_h \quad (2)$$



where  $\theta$  is a  $(k \times 1)$  vector of unknown parameters to be estimated and  $u_h$  is the normally distributed error term  $N(0, \sigma_u^2)$ .

The parameters  $\beta$  and  $\theta$  are estimated using a three-step Feasible Generalized Least Squares (FGLS). This procedure generates consistent estimates of  $\hat{\theta}$ , allowing equation (1) to be transformed so that the error term is homoscedastic. The consumption regression model can then be estimated using Ordinary Least Squares (OLS) to obtain consistent estimates of  $\hat{\beta}$ . Using these estimated parameters, we can obtain household-level expected log consumption:

$$\hat{E}[\ln C_h | \mathbf{X}_h] = \mathbf{X}_h' \hat{\beta} \quad (3)$$

and household-level variance of expected log consumption:

$$\hat{V}[\ln C_h | \mathbf{X}_h] = \hat{\sigma}_{e,h}^2 \hat{\theta} \quad (4)$$

Assuming a normal distribution for log consumption, vulnerability can be estimated as follows:

$$\hat{v}_h = \Pr(\ln C_h < \ln z | \mathbf{X}_h) = \Phi \left( \frac{\ln z - \mathbf{X}_h' \hat{\beta}}{\sqrt{\mathbf{X}_h' \hat{\theta}}} \right) \quad (5)$$

where  $z$  is the specified poverty line and  $\Phi(\cdot)$  is the standard cumulative normal density function.

Overall vulnerability incidence is then defined as the total number of vulnerable households, i.e., those households where the estimated vulnerability falls below a specified threshold in a given time horizon. Clearly, the measure of vulnerability incidence is sensitive to the choice of the vulnerability threshold ( $v_n$ ) and the time horizon ( $n$ ).

Following standard practice in the literature, we focus on the most commonly used threshold for vulnerability

incidence,  $v_n = 0.5$ , defined over a three-year time horizon, i.e., the probability of falling into consumption poverty at least once in the next *three years*.<sup>108</sup>

The advantage of this approach is that it does not require panel datasets that are rare in developing countries and can be used to assess vulnerability based on cross-sectional data. Additionally, the methodology yields an overall incidence of vulnerability measure that is analogous to the commonly used poverty headcount ratio and is familiar to policy-makers. Note that the measure of vulnerability already incorporates the use of coping mechanisms (as it is defined in terms of observed consumption expenditure) and thus, reflects both income risk and the use of smoothing (Pritchett, Suryahadi, and Sumarto 2000). On the flipside, the shortcomings of this approach relate to the strong assumptions that are required to assess vulnerability from a single cross-section (see Chaudhuri 2000 for details)—one, inter-temporal variance can be proxied by cross-sectional variance across households at a sufficient level of disaggregation; two, the structure of the economy is stable so only idiosyncratic shocks enter the model through the error term.

### Data and Variables Used in Estimation

We estimate separate consumption regression models for rural and urban areas of Himachal Pradesh using the 1999–2000 large-scale National Sample Survey consumption schedules, as per the methodology outlined above. The variables used to explain log consumption include household head characteristics (including age, gender, marital status, educational attainment), household demographics (such as household size, number of children and elderly in the household), main economic activity of the household (i.e., whether the household is primarily self-employed in agricultural or non-agricultural activities, primarily engaged in regular wage or casual

<sup>108</sup> Note that, by definition, provided the sample is large and normally distributed, the estimated mean vulnerability should tend towards the observed poverty rate.



wage—agricultural and non-agricultural in rural areas—employment or other activities), land owned and facilities (whether the house is electrified), other household characteristics (including caste and religion

background) as well as controls for seasonality. The impacts on household log per capita consumption of the majority of these variables are broadly plausible. Results are reported below.

Dependent Variable = Log Monthly Per Capita Consumption		
	Rural	Urban
HH head age	0.0205*** (0.0041)	0.0016 (0.0064)
HH head age, squared	-0.0001*** (0.0000)	0.0000 (0.0001)
HH head male	-0.1369*** (0.0307)	-0.0992 (0.0639)
HH head married	-0.1571** (0.0694)	0.0745 (0.0520)
HH head widowed	-0.1909** (0.0792)	0.1086 (0.1019)
Female HH head widowed	-0.1310** (0.0546)	-0.1787 (0.1133)
HH head completed primary school	0.1150*** (0.0250)	-0.0035 (0.0452)
HH head completed middle school	0.1817*** (0.0313)	0.1615*** (0.0490)
HH head completed secondary school	0.3035*** (0.0240)	0.3202*** (0.0350)
HH head completed graduate school	0.4979*** (0.0565)	0.5327*** (0.0394)
HH size	-0.1536*** (0.0110)	-0.1918*** (0.0202)
HH size, squared	0.0073*** (0.0008)	0.0115*** (0.0021)
No. of children aged 0–6 years in HH	-0.0403*** (0.0102)	-0.1023*** (0.0212)
Muslim	0.2386*** (0.0563)	-0.1558** (0.0733)
Scheduled caste	-0.0967*** (0.0217)	-0.1495*** (0.0309)
Scheduled tribe	-0.0029 (0.0385)	-0.0259 (0.2272)
Self-employed		0.0828* (0.0434)



Dependent Variable = Log Monthly Per Capita Consumption		
Self-employed in agriculture	-0.1052*** (0.0253)	
Self-employed in non-agriculture	-0.0814*** (0.0298)	
Casual labour		-0.1051* (0.0597)
Casual agricultural labour	-0.2367*** (0.0501)	
Other casual labour	-0.1982*** (0.0336)	
Regular wage/salary earnings		0.1401*** (0.0403)
Land owned (logs)	-0.0254 (0.0308)	-0.0369 (0.0305)
Prop. of cultivated land irrigated	0.0243 (0.0281)	
HH is electrified	0.1737*** (0.0388)	0.2020*** (0.0692)
HH interviewed in Apr–Jun	0.0163 (0.0232)	0.0256 (0.0326)
HH interviewed in Jul–Sep	0.0348 (0.0237)	0.0512 (0.0330)
HH interviewed in Oct–Dec	-0.0083 (0.0239)	-0.0486 (0.0309)
Constant	6.5818*** (0.1194)	7.0278*** (0.1431)
Observations	1620	929
Standard errors in parentheses		
* significant at 10%; ** significant at 5%; *** significant at 1%		



## Annex 4. Details of Loss-Making PSEs

Figures in Rs. 100,000s			
Name of company	Net Profit/Loss*	Accumulated Profit/Loss	Paid up Capital
HP Road Transport Corporation	-3189.27	-36712.72	25250.76
HP State Electricity Board	-3724.64	-25964.06	28211.18
HP Financial Corporation	-250.65	-8499.35	2817.11
Agro Industrial Packaging India Ltd	-580.51	-5085.53	1772
HP State Forest Corporation	-959.28	-1563.92	1208.06
HP State Handicrafts and Handloom Corporation Ltd	-121.91	-972.25	414.16
HP Tourism Development Corporation Ltd	-36.75	-903.70	1229.86
HP Agro Industries Corporation Ltd	-10.68	-471.11	1180.08
HP State Electronics Development Corporation Ltd	-28.07	-414.53	371.67
HP Minorities Finance and Development Corporation	-28.02	-112.73	197.42
HP Mahila Vikas Nigam	-2.02	-4.06	196.92

\* Latest year for which accounts were finalized. Shaded rows indicate PSEs with eroded paid up capital.



# Annex 5. Fiscal Projections and Debt Sustainability Analysis

## Fiscal Projections

The Government of Himachal Pradesh had produced medium term fiscal projections that were tabled along with the Budget for 2007–08. The projections were subsequently revised to reflect stronger improvement in expenditure composition and fiscal correction. The revised framework is outlined below. The MTFP is broadly consistent with the Himachal Pradesh FRBM, 2005 and aligned with TFC's recommendations. The MTFP targets elimination of GoHP's current deficit in 2008–09 and reducing the ratio of gross fiscal deficit to GSDP from 4.3 percent in 2006–07 to 2.2 percent by 2011–12. Going forward, GoHP plans to execute its budget to meet the 2007–08 MTFP targets, and prepare the 2008–09 budget in alignment with the MTFP targets for that year. GSDP is expected to grow at a nominal rate of 14 percent, which is broadly consistent with a real rate of growth of 8 percent.

**Revenue.** The projections indicate an annual growth rate of roughly 16 percent in own tax revenues (and a buoyancy of around 1.1). This seems achievable,

given that the state has announced several encouraging measures in its 2007–08 budget to raise its own tax revenue. These include raising the motor vehicle tax on personal vehicles from 2 percent to 5 percent, and to prevailing national levels by 2011–12, levying a green tax on vehicles over 15 years old, and a hotel tax based on notional minimum occupancy. The state excise regime has been revised to a vendor-wise auction regime, with annual license fee linked to minimum guaranteed quota that is based on past trend in sales. As a percent of GSDP, the state's own tax effort is forecast to increase from 5.2 percent in 2006–07 (RE) to 6.5 percent by 2011–12. Non-tax revenues show a growth of a little over 10 percent annually. These are fairly conservative, given that non-tax revenue has grown rapidly from 2002–03 onwards at an average of 45 percent year on year, largely on account of revenue from sale of hydropower. Central taxes and grants are projected to decline from 15.7 percent of GSDP in 2006–07 (RE) to 14.9 percent by 2011–12. The revenue effort is projected at an almost even 24 percent of GSDP through the MTFP period, in part because of a conservative forecast of share of non-tax revenue.

**Table A5.1: Revenues under the MTFP (Percentage of GSDP)**

	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10	2010–11	2011–12
	Actual	Actual	R.E	Proj	Proj	Proj	Proj	Proj
Total Revenue	20.1	25.8	24.0	23.5	23.5	23.6	23.8	24.0
State's Own Revenues	8.0	8.6	8.3	8.8	8.9	8.9	8.9	9.1
Tax	5.4	5.9	5.2	6.1	6.2	6.3	6.4	6.5
Non-Tax	2.6	2.7	3.0	2.7	2.7	2.7	2.6	2.6
Central Taxes and Grants	12.1	17.2	15.7	14.7	14.7	14.7	14.9	14.9
Shared Taxes	2.3	1.9	2.0	2.4	2.5	2.7	2.9	3.1
Grants	9.8	15.2	13.6	12.3	12.1	12.0	12.0	11.8



Table A5.2: Expenditure Composition as a percent of Total Expenditure

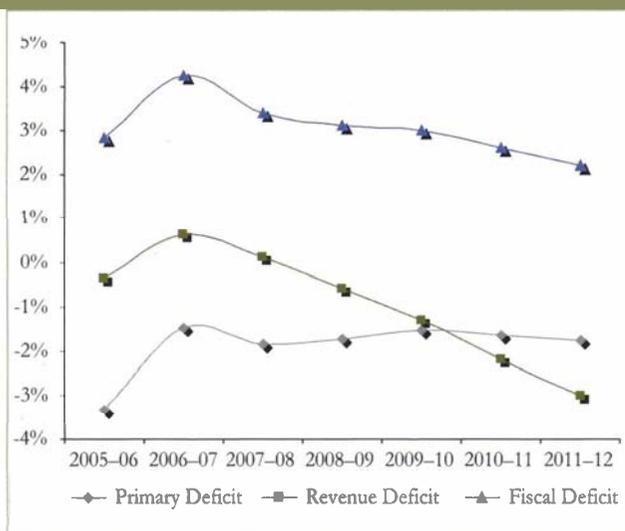
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
	Actual	Actual	R.E	Proj	Proj	Proj	Proj	Proj
Salaries	36%	35%	33%	34%	34%	33%	31%	30%
Pensions and Retirement Benefits	9%	10%	10%	10%	10%	10%	10%	9%
Non Wage O&M	10%	11%	13%	13%	14%	15%	17%	18%
Subsidies and Transfers	7%	7%	8%	9%	8%	7%	6%	5%
Interest Payments	25%	21%	20%	20%	18%	17%	16%	15%
Capital Outlay & Net Lending	10%	11%	13%	12%	14%	16%	18%	20%

**Expenditure.** The projections indicate that GoHP recognizes the need to improve expenditure composition towards capital outlay and critical non-wage O&M. The MTFP attempts to: (i) reduce share of salary expenditure to total expenditure to 30 percent by 2011-12, from 35 percent in 2005-06; (ii) decrease interest expenditure to revenue receipts to 17 percent by 2011-12 (i.e. by 5 percentage points of revenue expenditure from 21 percent in 2005-06); and (iii) increase non-wage O&M and capital outlay to 18 percent and 20 percent of total expenditure respectively by 2011-12 (Table A4.2). The underlying basis of the forecast has been strengthened to reflect hiring plans, attrition, inflation indexation of

wages, likely impact of the next Pay Commission, and wage creep in the salary projections. Subsidies and transfers remain fairly constant in absolute terms.

While the projections may not meet Twelfth Finance Commission's guidelines on salaries (35 percent of revenue expenditure net of interest payments and pension) and interest expenditure (15 percent by 2009-10), they do meet the Twelfth Finance Commission targets of elimination of revenue deficit and a fiscal deficit ratio of 3 percent of GSDP. Moreover, what is important is that the projections do show a story of consistent fiscal improvement. The proposed fiscal trajectory is shown in Figure A5.1.

Figure A5.1: Projected Fiscal Trajectory



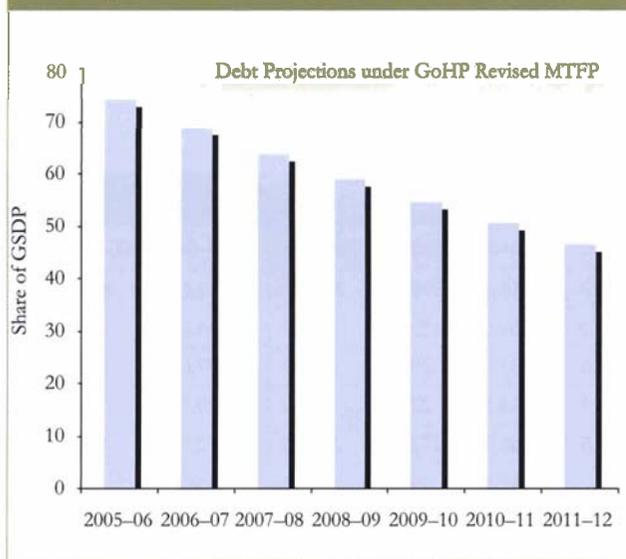
### Debt Sustainability Analysis

The state, in its medium term fiscal projections, predicts that debt will reach around 47 percent of GSDP by 2011-12. While the state, in the past, has not been reporting off-budget liabilities, and thereby underestimating the actual level of debt, it is now making an effort to consolidate the outstanding off and on budget debt for fiscal management purposes. Figure A5.2 below gives the debt projections as per the government's projections, after including off-budget liabilities from 2005-06 onwards. The debt stock is expected to decrease by over 20 percent over the next six years.

Stress tests were carried out to check the robustness of the projected debt trajectory to economic and fiscal



Figure A5.2: Projected Debt Stock



stress test, in the steady state, real interest rate is initially assumed at 5.5 percent—stabilizing to 5 percent from 2008–09. GSDP growth starts at 8.5 percent, and moves gradually towards a long term growth rate of around 7 percent by 2016.

Under steady state conditions of the MTFP, if projected forward to 2020, debt to GSDP ratio should decrease to about 35 percent in 15 years time. However, a shock to GSDP growth of 2.5 percent in 2011–12 could slow the reduction of debt to GSDP to 38 percent by 2020. In a second test, a decline in central transfers of an order of 5 percent annually from 2010–11 onwards, will raise the end period debt to GSDP ratio to 46 percent. Finally, decline in central transfers of the order of 5 percent annually from 2010–11 onwards, combined with an interest rate

Table A5.3: Debt Projections under Varying Scenarios (percent GSDP)

Scenarios	2005	2010	2015	2020
Baseline plus shock to growth rates in 2010–11 and 2011–12	74	57.5	46.9	37.9
Baseline plus a possible decline in central transfers starting 2010	74	58.0	55.8	46.1
Baseline plus decline in central transfers plus interest rate shock in 2010–2011	74	59.7	58.8	48.8

shocks. These tests are mainly indicative. The purpose of the exercise is only to demonstrate the need for continued maintenance of fiscally sustainable policies over the medium term and the importance of robust and sustained fiscal correction to counter future uncertainties that can upset the trajectory of debt reduction. Table A4.3 below shows Himachal Pradesh's likely debt trajectory under different scenarios. For the

shock of 3 percentage points in 2010–11 and 2011–12, will raise the projected debt to GSDP ratio over the baseline by nearly 13 percent of GSDP in 2020 to 49 percent. To maintain the original debt trajectory in the face of shocks the state would have to generate higher primary surpluses. Clearly, the state needs to stay on a strong fiscal correction path over the medium term.



## Annex 6. Fiscal Data for HP

Himachal Pradesh: Fiscal Summary									
Rs Crore	1990-91	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07 (R.E)
<b>Revenue</b>	<b>806.5</b>	<b>2992.6</b>	<b>3045.6</b>	<b>3715.8</b>	<b>3658.8</b>	<b>3980.9</b>	<b>4634.5</b>	<b>6558.6</b>	<b>6946.0</b>
State's Own Revenues	209.8	904.6	863.2	1089.0	1052.0	1259.3	1851.9	2186.6	2398.0
Tax	160.9	620.3	728.4	915.6	887.5	984.3	1251.9	1497.0	1516.6
Non-Tax	48.9	284.4	134.8	173.5	164.5	275.0	600.0	689.7	881.4
Central Taxes and Grants	596.7	2088.0	2182.3	2626.8	2606.7	2721.6	2782.6	4372.0	4548.0
Shared Taxes	188.0	552.0	330.3	325.1	347.6	449.6	537.3	493.3	592.9
Grants	408.7	1536.0	1852.0	2301.7	2259.1	2272.1	2245.3	3878.7	3955.1
<b>Non-Interest Expenditures</b>	<b>974.8</b>	<b>3639.4</b>	<b>3911.2</b>	<b>4030.2</b>	<b>4541.2</b>	<b>4810.0</b>	<b>4803.8</b>	<b>5715.6</b>	<b>6519.5</b>
Salaries (incl GIA for education)	470.7	1644.2	1758.6	1956.7	2147.3	2251.3	2301.6	2583.5	2728.1
Pensions & Retirement Benefits	50.8	474.4	421.6	440.3	488.6	532.6	590.7	714.8	800.0
Non-Wage O & M	164.2	604.8	623.5	516.0	455.9	613.0	613.2	780.8	1057.8
Other Revenue Expenditures	8.9	34.0	99.3	109.4	93.1	254.5	197.5	310.8	263.9
Subsidies and Transfers	96.3	327.3	446.6	357.0	497.2	382.1	448.8	512.8	615.3
Capital Outlay	149.2	553.9	548.7	649.8	859.7	784.8	654.0	820.8	1065.9
Net Lending	34.6	0.8	12.9	1.1	-0.6	-8.4	-2.0	-7.8	-11.4
<b>Primary Surplus (+)/ Deficit (-)</b>	<b>-168.3</b>	<b>-646.8</b>	<b>-865.6</b>	<b>-314.4</b>	<b>-882.4</b>	<b>-829.0</b>	<b>-169.3</b>	<b>843.0</b>	<b>426.5</b>
Interest Payments	109.2	736.8	979.2	1196.9	1459.2	1554.6	1641.1	1563.5	1665.3
<b>Revenue Surplus (+)/ Deficit(-)</b>	<b>-93.8</b>	<b>-828.9</b>	<b>-1283.2</b>	<b>-860.5</b>	<b>-1482.4</b>	<b>-1607.2</b>	<b>-1158.4</b>	<b>92.5</b>	<b>-184.3</b>
<b>Fiscal Surplus (+)/Deficit(-)</b>	<b>-277.5</b>	<b>-1383.6</b>	<b>-1844.8</b>	<b>-1511.3</b>	<b>-2341.6</b>	<b>-2383.6</b>	<b>-1810.4</b>	<b>-720.5</b>	<b>-1238.8</b>
<b>Debt Stock</b>	<b>1294.0</b>	<b>7330.4</b>	<b>8728.8</b>	<b>10359.3</b>	<b>12149.7</b>	<b>14293.0</b>	<b>15571.4</b>	<b>18850.7</b>	<b>19942.8</b>
<b>Guarantees</b>	<b>403.3</b>	<b>1874.7</b>	<b>3061.0</b>	<b>4285.0</b>	<b>4428.3</b>	<b>4809.8</b>	<b>4315.5</b>	<b>3553.3</b>	<b>2129.51*</b>
GSDP	2815.2	14112.5	15661.2	17148.2	18904.7	20721.0	23024.0	25435.0	28995.9

\* Guarantees pertaining to the Himachal Housing Board, HP Forest Corporation, HPRIDC and HPIDB have been retired by merging their off budget borrowing with on-budget debt.



Himachal Pradesh: Fiscal Summary									
% GSDP	1990-91	1999-2000	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07 (R.E)
<b>Revenue</b>	<b>28.6</b>	<b>21.2</b>	<b>19.4</b>	<b>21.7</b>	<b>19.4</b>	<b>19.2</b>	<b>20.1</b>	<b>25.8</b>	<b>24.0</b>
State's Own Revenues	7.5	6.4	5.5	6.4	5.6	6.1	8.0	8.6	8.3
Tax	5.7	4.4	4.7	5.3	4.7	4.8	5.4	5.9	5.2
Non- Tax	1.7	2.0	0.9	1.0	0.9	1.3	2.6	2.7	3.0
Central Taxes and Grants	21.2	14.8	13.9	15.3	13.8	13.1	12.1	17.2	15.7
Shared Taxes	6.7	3.9	2.1	1.9	1.8	2.2	2.3	1.9	2.0
Grants	14.5	10.9	11.8	13.4	11.9	11.0	9.8	15.2	13.6
<b>Non-Interest Expenditures</b>	<b>34.6</b>	<b>25.8</b>	<b>25.0</b>	<b>23.5</b>	<b>24.0</b>	<b>23.2</b>	<b>20.9</b>	<b>22.5</b>	<b>22.5</b>
Salaries (incl GIA for education)	16.7	11.7	11.2	11.4	11.4	10.9	10.0	10.2	9.4
Pensions & Retirement Benefits	1.8	3.4	2.7	2.6	2.6	2.6	2.6	2.8	2.8
Non-Wage O & M	5.8	4.3	4.0	3.0	2.4	3.0	2.7	3.1	3.6
Other Revenue Expenditures	0.3	0.2	0.6	0.6	0.5	1.2	0.9	1.2	0.9
Subsidies and Transfers	3.4	2.3	2.9	2.1	2.6	1.8	1.9	2.0	2.1
Capital Outlay	5.3	3.9	3.5	3.8	4.5	3.8	2.8	3.2	3.7
Net Lending	1.2	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
<b>Primary Surplus (+)/deficit (-)</b>	<b>-6.0</b>	<b>-4.6</b>	<b>-5.5</b>	<b>-1.8</b>	<b>-4.7</b>	<b>-4.0</b>	<b>-0.7</b>	<b>3.3</b>	<b>1.5</b>
Interest Payments	3.9	5.2	6.3	7.0	7.7	7.5	7.1	6.1	5.7
<b>Revenue Surplus (+)/Deficit(-)</b>	<b>-3.3</b>	<b>-5.9</b>	<b>-8.2</b>	<b>-5.0</b>	<b>-7.8</b>	<b>-7.8</b>	<b>-5.0</b>	<b>0.4</b>	<b>-0.6</b>
<b>Fiscal Surplus (+)/Deficit(-)</b>	<b>-9.9</b>	<b>-9.8</b>	<b>-11.8</b>	<b>-8.8</b>	<b>-12.4</b>	<b>-11.5</b>	<b>-7.9</b>	<b>-2.8</b>	<b>-4.3</b>
<b>Debt Stock</b>	<b>46.0</b>	<b>51.9</b>	<b>55.7</b>	<b>60.4</b>	<b>64.3</b>	<b>69.0</b>	<b>67.6</b>	<b>74.1</b>	<b>68.8</b>
<b>Guarantees</b>	<b>14.3</b>	<b>13.3</b>	<b>19.5</b>	<b>25.0</b>	<b>23.4</b>	<b>23.2</b>	<b>18.7</b>	<b>14.0</b>	<b>7.3</b>



<b>Himachal Pradesh: Fiscal Projections under Revised MTFP</b>					
<b>Rs Crore</b>	<b>2007–08 (Proj)</b>	<b>2008–09 (Proj)</b>	<b>2009–10 (Proj)</b>	<b>2010–11 (Proj)</b>	<b>2011–12 (Proj)</b>
<b>Revenue</b>	<b>7760.0</b>	<b>8861.7</b>	<b>10156.9</b>	<b>11658.6</b>	<b>13379.7</b>
State's Own Revenues	2900.0	3340.0	3831.2	4375.8	5063.4
Tax	2000.0	2330.0	2691.2	3121.8	3621.3
Non-Tax	900.0	1010.0	1140.0	1254.0	1442.1
Central Taxes and Grants	4860.0	5521.7	6325.7	7282.8	8316.4
Shared Taxes	785.0	957.7	1168.4	1425.4	1739.0
Grants	4075.0	4564.0	5157.3	5857.3	6577.3
<b>Non-Interest Expenditures</b>	<b>7149.4</b>	<b>8213.6</b>	<b>9499.7</b>	<b>10861.4</b>	<b>12409.3</b>
Salaries (incl GIA for education)	3014.4	3414.4	3777.9	4023.2	4385.4
Pensions & Retirement Benefits	915.0	974.1	1087.6	1229.0	1388.7
Non-Wage O & M	1111.5	1385.8	1717.2	2161.7	2587.4
Other Revenue Expenditures	244.0	261.1	295.4	323.4	356.7
Subsidies and Transfers	777.7	778.3	778.5	782.7	782.1
Capital Outlay	1093.2	1409.9	1854.6	2354.4	2923.6
Net Lending	-6.3	-10.0	-11.4	-12.9	-14.6
Interest Payments-with DPL	1737.0	1829.1	1948.0	2074.7	2209.5
<b>Primary Surplus (+)/Deficit (-)</b>	<b>610.6</b>	<b>648.1</b>	<b>657.2</b>	<b>797.1</b>	<b>970.4</b>
<b>Revenue Surplus (+)/Deficit(-)</b>	<b>-39.6</b>	<b>218.9</b>	<b>552.4</b>	<b>1064.0</b>	<b>1669.9</b>
<b>Fiscal Surplus (+)/Deficit(-)</b>	<b>-1126.4</b>	<b>-1181.0</b>	<b>-1290.8</b>	<b>-1277.5</b>	<b>-1239.1</b>
<b>Debt Stock</b>	<b>21069.3</b>	<b>22250.3</b>	<b>23541.1</b>	<b>24818.6</b>	<b>26057.7</b>
GSDP	33055.3	37683.1	42958.7	48972.9	55829.1



Himachal Pradesh: Fiscal Projections under Revised MTFP					
% GSDP	2007-08 (Proj)	2008-09 (Proj)	2009-10 (Proj)	2010-11 (Proj)	2011-12 (Proj)
<b>Revenue</b>	<b>23.5</b>	<b>23.5</b>	<b>23.6</b>	<b>23.8</b>	<b>24.0</b>
State's Own Revenues	8.8	8.9	8.9	8.9	9.1
Tax	6.1	6.2	6.3	6.4	6.5
Non- Tax	2.7	2.7	2.7	2.6	2.6
Central Taxes and Grants	14.7	14.7	14.7	14.9	14.9
Shared Taxes	2.4	2.5	2.7	2.9	3.1
Grants	12.3	12.1	12.0	12.0	11.8
<b>Non-Interest Expenditures</b>	<b>21.6</b>	<b>21.8</b>	<b>22.1</b>	<b>22.2</b>	<b>22.2</b>
Salaries (incl GIA for education)	9.1	9.1	8.8	8.2	7.9
Pensions & Retirement Benefits	2.8	2.6	2.5	2.5	2.5
Non- Wage O & M	3.4	3.7	4.0	4.4	4.6
Other Revenue Expenditures	0.7	0.7	0.7	0.7	0.6
Subsidies and Transfers	2.4	2.1	1.8	1.6	1.4
Capital Outlay	3.3	3.7	4.3	4.8	5.2
Net Lending	0.0	0.0	0.0	0.0	0.0
Interest Payments-with DPL	5.3	4.9	4.5	4.2	4.0
<b>Primary Surplus (+)/Deficit (-)</b>	<b>1.8</b>	<b>1.7</b>	<b>1.5</b>	<b>1.6</b>	<b>1.7</b>
<b>Revenue Surplus (+)/Deficit(-)</b>	<b>-0.1</b>	<b>0.6</b>	<b>1.3</b>	<b>2.2</b>	<b>3.0</b>
<b>Fiscal Surplus (+)/Deficit(-)</b>	<b>-3.4</b>	<b>-3.1</b>	<b>-3.0</b>	<b>-2.6</b>	<b>-2.2</b>
<b>Debt Stock</b>	<b>63.7</b>	<b>59.0</b>	<b>54.8</b>	<b>50.7</b>	<b>46.7</b>



# Annex 7. Preliminary Assessment of Public Financial Management and Procurement

## A. Introduction

The purpose of this Annex is to provide a preliminary assessment of the Public Financial Management System in Government of Himachal Pradesh (GoHP).

This note has been prepared based on findings of a World Bank team which visited Himachal Pradesh (HP) during October 16–19 and then during October 26–November 3, 2006. The Bank team met with Officials of GoHP, Public Accounts Committee, Auditor General (AG), Controller of Stores in Shimla and reviewed relevant documents (Finance Accounts, Appropriation Accounts, C&AG Audit Reports, Procedures & Rules for the Purchase of Stores, Industrial Policy Rules, and various Acts and Rules etc.) during the course of its work.

## B. Budget Formulation and Execution

**Budgetary Framework:** The framework for Budgeting and Accounting in GoHP is divided in the following three parts; this is similar to the structure for any other Indian state.

Part I—*Consolidated Fund:* Most of the transactions of the state flow through the Consolidated Fund.<sup>109</sup> These include taxation and other receipts, capital receipts and proceeds from loans raised by the State Government on

the receipt side. On the expenditure side these include revenue expenditure, expenditure on creation of assets and repayment of loans.

Part II—*Contingency Fund:* This fund is established to meet transactions of an unforeseen or urgent nature; currently balance in the fund is Rs. 5 crores.

Part III—*Public Account:* This includes transactions relating to deposits, advances, remittances and suspense; in cases where the government acts as a banker or trustee. This may include Provident/Pension Funds, various reserve and development funds, deposits relating to various departments, and suspense/temporary accounts which are expected to be closed through offsetting transactions. The Public Account also holds the cash reserves of the state government.

**Chart of Accounts:** A budget document provides details of budget-estimates for the coming financial year. The budget estimates are prepared for different heads of accounts which are based on a uniform classification system as adopted by most states. As stated above, at the broadest level all transactions are classified into one of the funds. Consolidated Fund is divided into Revenue and Capital sections, which are further broken down into sectors and sub-sectors. The sub-sectors are further divided into a six-tier hierarchical structure, classified as follows:

- Major Head—a major function of the Government
- Sub-Major Head—a sub-function

<sup>109</sup> Funds which are received directly by the implementing agencies (e.g. State Societies in case of Health or Primary Education or DRDAs in case of Rural Development Schemes) under Centrally Sponsored Schemes would normally not be reflected in the State Budget or Annual Financial Statements.



- Minor Head—a programme
- Sub-Head—a scheme
- Detailed Head—a sub-scheme
- Object Head—standard object of expenditure

This classification implies that the budget is very detailed and consequently the implementing departments have limited flexibility during the year to be able to shift resources from one scheme to another. This shift may be warranted in case there is slow progress on one scheme and fast progress on another; both being implemented by the same Department. In such instances, the shift may be made only with approval of the Finance Department; which tends to delay optimum utilization of resources<sup>110</sup>.

**Budget Preparation:** Framework for preparation of the budget is as per the Budget Manual, 1972. Though there has been no major review of this document till date, circulars/directions are issued by the GoHP from time to time to meet any new developments/requirements. The budget is prepared on a cash basis and is divided into two parts i.e. Plan part which is the responsibility of the Planning Department<sup>111</sup>, while the non-Plan part which mainly consists of salaries, establishment and other recurrent expenditure which is prepared by the Finance Department based on detailed information<sup>112</sup> provided by other departments.

**The Planning/Budgeting Process:** In HP, the Plan size is much smaller than the Non Plan outlay, salaries, pension and interest account for 70 percent of expenditure; moreover focus of departments during the course of budgeting for Plan Funds tends to be on schemes, rather than needs. Though there is

a conscious effort in terms of scheme prioritization, still steps should be taken to bring more of an outcome focus in the Budget. An outcome budget would clearly articulate objectives, financial outlays, deliverables/physical outputs and desired outcomes of a program/scheme; it is intended to bring in a higher level of accountability for results. GoI has recently moved in this direction by presenting its first outcome budget for FY 2005–06; other Indian states are also moving in this direction.<sup>113</sup> Towards garnering maximum resources for development, the state also needs to ensure that it gets the best possible allocations out of the Centrally Sponsored Schemes<sup>114</sup> with high rates of utilization of these allocations.

**The Budget Document:** The Annual Budget has the following features:

- The Budget is a very detailed document with information on receipts and payments; it is supported by a detailed book for each of the 31 grants. The budget document is not easily understood by readers, in terms of level of detail as well as description of the heads and sub-heads. Though an attempt has been made to summarize/explain the same through an Explanatory Memorandum; much more needs to be done in terms of presentation to enable the public to understand and analyze it.
- The Budget becomes a public document after it is tabled in the state legislature. It is also available on the GoHP website; however as explained above, it is not easy to comprehend.

**Legislative Approval:** The State Legislature is required to approve the budget as part of an annual Appropriations

<sup>110</sup> See Paragraph 10 of this Annex, on Budgetary Control.

<sup>111</sup> Planning department prepares an overall Plan outlay for the year; this depends upon a number of factors including the Annual Plan Approach Paper and the Five Year Plan. For determination of department-wise outlay, it normally considers past outlays, any guidelines for growth the Approach Paper has identified, and specific schemes launched by GoI.

<sup>112</sup> Departments prepare salary and other recurring part of the budget with full details, including list of employees, etc. The information is collected and compiled at the Directorate level in each department.

<sup>113</sup> E.g. Karnataka has moved towards Outcome based Programme Budgeting.

<sup>114</sup> In case of the Sarva Shiksha Abhiyaan, the state spent 69% and 83% of its Annual Work Plan and Budget for FY 2004–05, 2005–06 respectively.



Act; this is mandated as per the Constitution of India. In case supplementary or additional grants are required during the year, the same also need a similar approval. If the Budget is not passed before commencement of a year, a Vote On Account is required to enable expenditure in the initial months of the financial year. Timings of approval of the budget in GoHP are reasonable; the last two budgets i.e. for 2005–06 and 2006–07 have been approved before March 31, 2005 and 2006 respectively.<sup>115</sup>

It is mandatory for all state governments to obtain legislative approval for any excess over a grant/appropriation by the state legislature. In HP a total of Rs 13,871.86 crores of excess spending since FY 2001–02 requires approval of the legislature. In the past, this process of regularization is understood to be taking a period of 4–5 years; this process needs to be reviewed both in context of minimizing the excess as well as in reducing the time taken for regularization.

- *At the Departmental level* any request for additional budget has to be made to the Finance Department, which if convinced of the requirement, would normally sanction an ‘additionality’ (specific approval/additional allocation) to the department with copies to Treasury and AG (A&E). The ‘additionalities’ are a way of reducing the number of supplementary budget provisions which is done only once<sup>117</sup> towards the end of the financial year. Around September/October, the Finance Department instructs all departments to submit budget proposals for the next year along with revised budget estimates for the current year. Thus providing opportunity to the departments to not only identify additional budget requirement but also surrender any likely excess budget provisions.

**Budget Marksmanship/Accuracy:** CAG has pointed out a number of excess/savings in the grants provided in the budget. However a significant part of the variations

#### GoHP: Excess over provision requiring regularization

Year	2001–02	2002–03	2003–04	2004–05	Total
Rs. Crores	2,965.36	3,295.74	4,515.58	3,095.12	13,871.80

**Budgetary Control:** GoHP exercises control over budgeted expenditure, through a number of processes.

- *At the transaction level*, the Finance Officer at the spending department scrutinizes the payment request for various checks, including availability of the budget. Further, the Treasury ensures that only those payments are processed, for which budget is available<sup>116</sup>.

related to repayment of overdrafts/ways and means advances<sup>118</sup> in FY 2003–04, 2004–05.

However, an analysis of excesses in case of select departments/grants indicates significant variations over the years; reasons for the same need to be analyzed and furthermore there is a need to improve the process of monitoring.

<sup>115</sup> However earlier budgets were passed as per the following timelines; 2004–05 by June 30, 2004 and 2003–04 by July 16, 2003.

<sup>116</sup> In practice, since the sub-treasuries are not computerized and therefore not able to get real time information on budget availability (for a particular DDO under a specific head), there are possibilities where the actual expenditure may exceed the budget allocated.

<sup>117</sup> While the total number of additionalities during the year may be as large as 200, in the past only one supplementary budget provision was made encompassing all the additionalities.

<sup>118</sup> For this purpose, the CAG considers each repayment of overdraft as an expenditure.



### GoHP: Excess utilization of Grants (%)

Grant	2004–05	Financial Year 2003–04
Public Works	56.2%	76.9%
Road & Water Transport	61.5%	80.9%
WSS, Housing & Urban	79.1%	173.9%

## C. Rules for Accounting, Procurement and Financial Reporting

**Financial Rules:** Accounting and Financial Control including Procurement in HP is guided by ‘The Himachal Pradesh Financial Rules, 1971’. These rules cover areas such as General Principles, Budget, Revenue Receipts, Pay, Allowances & Pensions, Stores, Works etc. Prima Facie, the Rules seem difficult to interpret and require reference to circulars released since issue of the Rules; these need to be updated and significantly simplified.

The General Financial Rules (GFR) of Government of India (GoI) have been revised in 2005. This was done through a task force setup with the objective of reviewing and revising the rules. The Report of the Task Force states *“The GFRs, 1963 were issued as a compendium of instructions for guidance of government officers dealing with matters of a financial nature, have been in force for over four decades. A large number of the original rules have fallen into disuse due to changes in the environment in which government departments operate. Rapid growth of alternative service delivery systems, developments in information technology and the expectations of the public that Government should render timely, efficient and quality service has necessitated a comprehensive review of the government financial management systems, so as to ensure transparency, accountability and effectiveness...”* These facts are equally relevant for any Indian state. A revision of the Rules (possibly using the GoI GFRs as a base) would ensure that the framework guiding financial management is precise, easy to understand and contemporary.

Procurement in the HP is governed by Procedure & Rules for the Purchase of Stores, which is an appendix to GoHP Financial Rules. These are maintained by Controller of Stores under Ministry of Industries, and relate to procurement of goods. While the Store Purchase Organization is the nodal agency for negotiation of rate contracts, there is an increasing effort to decentralize department specific purchase to the respective departments. The existing rules provide a preference for domestic suppliers with an aim to promote the local industries. It needs to be reviewed whether such preferences actually result in the desired effect. Moreover, when procurement is decentralized, multiple rules & departmental regulations/instructions develop over time with little if any effort made to ensure consistency in the regulatory basis or clarity in regard to which rule applies when.

Simplification of laws and regulations is often best accomplished through the adoption of a modern procurement law that applies to all kinds of procurement undertaken using public funds (goods, works and services). States like Tamil Nadu and Karnataka have adopted modern procurement laws.

**Annual Accounts:** Annual Accounts of GoHP are prepared on a regular and a timely basis and provide considerable information. These consist of the Finance Accounts and the Appropriation Accounts.

- The Finance Accounts provide information (in form of 19 Statements and various appendices) on receipt and expenditure, borrowing and liabilities, loans and investments made, and cash balances. The formats are fairly consistent from year-to-year; in certain cases ‘balances till date’ are also provided.



- The Appropriation Accounts contain details of expenditure vis-à-vis the voted/charged appropriations for the year.

**Timeliness:** The Annual Accounts are usually ready within six months of close of the financial year; e.g. accounts for FY 2004–05 were approved by the C&AG on September 19, 2005. This is considered quite reasonable in comparison with many other Indian states. In terms of monthly<sup>119</sup> accounts, GoHP fares much better than most Indian states e.g. GoHP accounts for the month of July 2006 were available on the C&AG website in October 2006. This is an indicator of timeliness of accounting as well as a culture of openness in terms of readiness to share/disclose information.

#### **Responsibility for Preparation of Annual Accounts:**

The following points are of note.

- GoHP's Annual Accounts are prepared by the C&AG (Accounts and Entitlement Wing). The various spending departments send one set of original paid documents to the AG for compilation/consolidation of information for the entire state; this is done through the Voucher Level Consolidation (VLC) software.
- The accounts are certified by the C&AG of India; the certificate states that "Points of interest arising out of the study of these accounts as well as test audit conducted during the year or earlier years are contained in my Reports being presented separately for the year to the Government of Himachal Pradesh". Thus the C&AG clarifies that a report on audit of the accounts would be issued separately.
- Due to the process explained above, GoHP has only part ownership of the Annual Accounts. While on the one hand this ensures uniformity across the country, it also implies that accounting is

seen by state governments merely as a compliance function and the state government may not view it as a tool for management control.

**Completeness of Financial Information:** The following issues are of note.

- GoHP issues guarantees to assist state/public sector undertakings in borrowing funds and/or reducing the cost of their borrowings. As on March 31, 2005 the total amount of guarantees issued by the state government stood at Rs 6409 crores. Guarantees are capped under the HPFRBM at 80 percent of total revenue receipt in the preceding financial year for which actuals are available as per Finance Accounts. Also there is no system of assessing risk involved with each Guarantee and making provision to fund payments in case these are likely to be invoked.
- Since a cash basis of accounting is followed, the accounts do not present any information on revenue due but not collected, payables and outstanding commitments.
- Only the state share of the Centrally Sponsored Schemes (CSS) is reflected in the Financial Statements since usually GoI directly transfers funds<sup>120</sup> to the implementing entities for these programs. Since allocation to CSS is significant, the overall expenditure on the Schemes could be reflected as additional information in the Financial Statements.
- As explained in a subsequent section, though investments in Public Sector Enterprises (PSE) are disclosed at face value, the fact that the accumulated losses in the PSEs are greater than the investments, is not disclosed.

**Public Access to Procurement & Financial Information:** With passing of the Right to

<sup>119</sup> The CAG publishes monthly accounts of Indian states on its website. This is published with the following qualification "Comptroller and Auditor General of India is entrusted with maintaining the accounts of the state governments, in all the states except Goa. The position of summarised monthly accounts in case of states who have agreed to display on the web site is available here...".

<sup>120</sup> Few exceptions do exist where funds are initially received in the Consolidated Funds of the State, e.g. some schemes in the Rural Water Supply Sector.



Information Act, 2005 every public authority has the responsibility to provide specific information on its functions and activities. The act (Section 4 (2)) further states that *“it shall be the constant endeavor of every public authority to take steps to provide as much information suo moto to the public at regular intervals through various means of communications, including internet so that the public have minimum resort to use this Act to obtain information”*.

A disclosure policy could be help establish information that needs to be disclosed *suo moto*. Firstly, the formats for provision of information need to be simplified to ensure that information is easily understood by the general reader. Secondly, though the Annual Financial Statements are tabled in the state legislature, these are not widely debated so as to increase awareness amongst the general public. Thirdly, in context of non-financial information, Annual Performance Reports of departments could also be more widely disseminated including availability on the GoHP website.

**Drawing and Disbursal Officers (DDO):** There are approximately 3600 DDOs in the state; more than 2000 of these are School Headmasters whose role as a DDO is primarily for payment of salaries and miscellaneous expenses at schools. Each DDO position implies the entire cycle of accounting & book-keeping, reporting for consolidation, reconciliation and audit. The number of DDOs needs to be rationalized by introducing higher levels of automation/use of banking facilities or both. In the state of Uttar Pradesh for example, DDO positions were rationalized by following the principle of ‘one DDO per department per district’. Also to note that Tamil Nadu has moved to ECS salary payments for approx. 14 lakh employees (including school teachers) and proposes to extend the functionality for all payments including suppliers.

## D. Internal Control and Internal Auditing

**Reinforcing Responsibility and Accountability of the Head of the Department (HoD):** Though HoD is responsible for effective financial management for the department this needs to be more clearly stated in the relevant Rules/Codes. Sometimes it is a perception that these matters are responsibility of the Finance Department. This results in sub-optimal utilization of resources, weaknesses in internal controls, delay in response to audit reports etc. The GoI, in its revised GFRs, has included Rule 64 to more clearly articulate responsibility of the HoD. The Rule reads as follows; *“Rule 64. Duties and Responsibility of the Chief Accounting Authority—The Secretary of a Ministry/Department who is the Chief Accounting Authority of the Ministry/Department shall-... ”* and clearly lists down 9 areas of responsibility including responsibility for financial management, ensuring that funds are used for the purposes intended, responsible for full and proper maintenance of accounting records etc. The state can draw lessons from this to ensure that Accountability of the HoD is clearly established.

**Treasury Computerization:** HP has a Treasury System which is computerized at the state and district levels; the On-line Treasury Information System (OLTIS) in use has been developed by the National Informatics Centre (NIC). The state is in the process of installing a state-wide Wide Area Network (WAN) and the Treasury system is expected to be rolled out to a further 30 sub-treasuries<sup>121</sup> in the short term using the WAN. An additional but related aspect is a plan to develop a Personnel Management Information System (PMIS); this will have an impact on the Treasury since it is expected to automate payroll preparation and therefore improve controls related to this task.

<sup>121</sup> The state has a total of 85 sub-treasuries.



**Staff Capacities:** The GoHP has two types of staff discharging the responsibilities in context of the financial management function.

- **Accounting:** Finance Department in the GoHP has a dedicated cadre of (Subordinate Accounts Service) staff which are selected through the HP Public Services Commission. Staff with at least five years of experience are eligible for selection, and undergo around six months of training before they begin work. They are posted at various levels in all major departments and provide a level of independence in context of the financial matters of the department.
- **Treasury:** Similar to the above, the Treasury has a cadre of staff selected through the HP Administrative Service/others. This staff is responsible for checking documents/recording transactions in the treasury software; this processing includes ensuring availability of budget, checking signatures, adequacy of documentation etc.

The following points are of note. Firstly, this staff brings in an element of independence and thus strengthens internal control. Secondly, the skill development needs of staff need to be assessed; while training at entry is provided, there is no system of ongoing training. Thirdly, since both types of staff are under the same department and essentially working to strengthen internal control, it is most logical that staff have opportunities to discharge both the functions<sup>122</sup>; this would provide them with a wider range of experience and better opportunities for career progression; thus rendering them more effective and improving morale.

**Internal Audit (IA):** In context of the spending departments IA does not exist, however officers in various departments like Rural Development or Irrigation and Public Health are responsible for

‘inspection’<sup>123</sup>. Inspections are not very regular and do not exist in certain departments like Health & Family Welfare<sup>124</sup>, moreover information on results of inspections is available neither at the department nor at the state level. HP needs to establish an IA function by a strategic allocation of resources. A small, centralized, skilled internal audit team should be setup to conduct systemic reviews in areas of perceived risks.

**Examiner Local Fund Audit (ELFA):** Mandate of the ELFA is mainly to undertake audit of local funds generated out of local incomes/fees or donations. It has approximately 125 staff including 73 auditors who are required to cover over 600 School Boards, Himachal Urban Development Authority, Universities, Colleges, Market Committees, Temple Trusts etc. GoHP is reviewing the possibility of transferring the responsibility of audit of ULBs to the ELFA.

**Utilization Certificates:** In instances where funds are released in form of Grants to an Institution or Organization, the relevant agency is required to submit a Utilization Certificate (UC) confirming that the Grant has been spent for the intended purposes; this needs to be submitted within 12 months of the closure of the Financial Year. As on March 31, 2005 a total of 2859 UCs aggregating to Rs. 355.27 crores were due; this is an indicator of weakness in internal controls.

**Oversight of Procurement:** Procurement presently takes place amidst a large number of controllers and overseers. Improving oversight of procurement involves rationalizing control as well as increasing the ability of the government and the private sector to monitor performance. Actions may include: introducing performance monitoring of procurement; developing effective mechanisms to conduct internal and external auditing of procurement; creating trusted mechanisms

<sup>122</sup> In states like Tamil Nadu, a single cadre of staff work in Treasuries/are deputed to various departments.

<sup>123</sup> Inspection covered a number of issues including budget monitoring, status of Works, stores registers, status on double entry book-keeping, review of expenditure transactions, service records etc.

<sup>124</sup> Para 3.1.59 : CAG Civil report - 31-3-2004.



for receiving and responding to complaints; developing forums for receiving input from business groups and beneficiaries; and enhancing the disclosure of information on procurement.

**Improving Commercial Practices:** These can be accomplished through improved contracting, better inventory and asset management (e.g. IPH department is already undertaking inventory management initiatives), improved contract management and enforcement, effective dispute resolution procedures, and attention to interaction with the supplier community. E-procurement can help reduce transactional cost of procurement as well as result in cost savings for the government.

## E. External Audit

**Independence and Scope of External Audit:** The External auditor for the State Government is the Comptroller and Auditor General of India (CAG, India's Supreme Audit Institution) through its field office in HP (the Auditor General or AG); this is similar to the arrangements in all Indian states. Independence of the CAG is well established; drawing its functions and powers from the Constitution of India. The audit covers all expenditure departments, revenue receipts and select state public sector undertakings. Audit is broadly of the following types: (a) regularity or compliance audit covering aspects such as overpayments, failure to collect revenue, infructuous expenditure, inventory control, internal control etc, and (b) performance reviews which try to provide a picture of the performance of a particular department in the year. In the last two years the AG has conducted performance review each year covering key/major spending departments like Irrigation and Public Health, Revenue (2004–05), Health & Family Welfare and Public Works (2003–04).

**Audit Process and Coverage:** Audit is conducted on a “test basis”. This implies that frequency and coverage of audit are determined in context of the perceived risk and the amount of money involved. The initial process after completion of the audit is issue of an Inspection Report which is provided to the office audited and with an opportunity to respond to or ‘settle’ the observation. Only those audit paras/observations which are significant in nature and have not received a satisfactory reply from the office/department audited are included in the final Audit Report. This report is issued under the signatures of the (State) AG as well as the CAG.

**Timeliness:** Receipt of audit report has usually been within 11–12 months<sup>125</sup> of close of the financial year. This compares very well with other Indian states.

**Audit Management:** Response to inspection reports and preliminary audit paras is provided by the concerned departments; the Finance Department plays a coordinating role when the final audit report is received from the CAG. Overall the audit process will be strengthened if a centralized ‘Audit Committee’ is made responsible for a gamut of issues relating to audit. These would include monitoring timeliness/quality of responses of departments, assessment of systemic issues and timely action for the future and communication of the States’ priorities to the AG to ensure best value out of the audit.

## F. Legislative Oversight

**Public Accounts Committee (PAC)/Committee on Public Undertakings (COPU):** As per convention, the PAC in HP is headed by a member of the party in opposition; it has 11 members. Regular hearings of the PAC are held; an officer of the Finance Department is invited to participate. Once the Audit report issued

<sup>125</sup> For FY 2004–05, the Revenue Audit Report was finalized in November 05 and the Civil and Commercial Audit Report in February 06. For FY 2003–04 the Civil Audit Report was finalized in February 05 and the Commercial Audit Report by March 05.



by the CAG is received by the PAC, departments are asked to respond to different paragraphs; this is first done through an interview process and subsequently the department may be requested to submit an Action Taken Report (ATR). The response is examined by the committee and if not satisfied it may again ask for further examination.

While the PAC reviews areas of mainstream government as reported in the Civil/Revenue Audit Reports, the COPU examines aspects relating to the State Public Sector Undertakings as reported in the Commercial Audit Report. The COPU holds around 4 meetings in a month, and usually it review observations higher than Rs 10 lakh in value.

While the framework of PAC & COPU is an important instrument of enforcing public accountability, however in practice the process<sup>126</sup> is such that there is significant delay between the event and its resolution at these committees; e.g. the PAC submitted its report on Health and Family Welfare Department relating to Audit for FY 2000–01 in March 06. At present the PAC is examining audit report for FY 2002–03; traditionally the PAC has examined reports in a chronological order though there is nothing to prevent it from examining the latest available audit report i.e. for FY 2004–05 and then gradually going back in time to cover the backlog.

## G. Other Areas

While the main focus of the team's work was on State Government Departments through which bulk of

public funds currently flow; funds also flow through Urban Local Bodies (ULBs), Public Sector Enterprises (PSEs), and Rural Local Bodies (PRIs). Some of the aspects relating to these are discussed below.

**Urban Local Bodies.** HP has a total of 49 Urban Local Bodies (ULB) consisting of 1 Municipal Corporation (Shimla), 20 Municipal Councils and 28 Town Panchayats. Total revenues of ULBs for FY 2004–05 amounted to Rs 69 crores, consisting of own income of Rs 33 crores (48%) and Grants from GoHP of Rs. 35.6 crores (51%). Accounting Records in ULBs are maintained using single entry accounting system. Audit of the ULBs is undertaken by staff (deputed from Local Audit Department) working under The Director, Urban Development.

The following issues are of note:

- The Directorate of Urban Development is planning to undertake reforms in ULBs by shifting to double-entry system of accounting. These reforms are likely to be in a phased manner starting with the Shimla Municipal Corporation. GoHP may draw on experience of the ULBs in Karnataka which have made significant strides in the areas of double entry accounting and better disclosure of financial information including a higher level of involvement of its citizens.
- The Audit process has not been very regular and frequently audits undertaken have covered a period of 7–8 years at one stretch impacting effectiveness of audit. Status of the audits pending is summarized as follows:

Audit pending for number of years	< 1 year	1–3 years	4–5 years	6–8 years	8 years >
No. of ULBs	8	14	9	9	8
%	16.5%	29%	19%	19%	16.5%

<sup>126</sup> The accountability cycle is completed when the audit is conducted, report issued, PAC hearings held, responses received from the Government, and the PAC tables its reports in the State Legislature.



Above may be attributed to inadequacy of audit staff. Moreover utility/response to audit is limited; a large number of audit paras i.e. 16,853<sup>127</sup> for different ULBs are required to be settled.

- GoHP is reviewing transfer of the Audit function of ULBs under the ELFA, this will have a positive impact on the quality and timeliness of audit.

**Public Sector Enterprises.** On date there are 21 Government PSEs in the state with a total investment of Rs 4920.30 crores including Equity 730.32 cr and Loans etc. Rs. 4189.98 Cr<sup>128</sup>. GoHP received a dividend of Rs 70.30 lakhs on this investment; the policy of a minimum dividend<sup>129</sup> of 3% was complied with, by only one company.

Many of these PSEs have been incurring financial losses over the years and the cumulative position of losses is Rs. 894.88 crores. Thus total investment of GoHP in these PSEs has been completely eroded. While the total investment of GoHP in the PSEs is presented in the Finance Accounts (Statement 14) the position of accumulated losses is not provided, thus providing an inaccurate picture of the status of investment.

Audit of HPSEB and HRTC are undertaken by the AG, while audit of most of the other Government Companies is undertaken by a firm of chartered accountants appointed by CAG under the Companies Act, 1956. Of the 17 working companies, audit of six companies were delayed by one-two year while the delay was five years for the HP Electricity Regulatory Commission.

A preliminary reading of the Audited Annual Financial Statements of HP State Electricity Board and Himachal

Road Transport Corporation reveals that the reports provide useful information on operation of the entities for the given period and the audit reports provide an overall opinion on true & fair status of the financial statements; however quality of presentation could be improved including a clearer statement of the Accounting Policies.

Monitoring of financial management policies/practices of the PSEs at the state level is negligible. This needs to be strengthened. This could be started with review of the two largest PSEs, looking at their existing Financial Management and Procurement Policies to identify performance improvement areas.

**Rural local Bodies.** HP has 3243 Gram Panchayats<sup>130</sup> (GP) (Village level), 75 Panchayat Samitis (PS) (Block level) and 12 Zilla Parishads (ZP) (District level). The Panchayati Raj Department assumes overall responsibility for the Rural Local Bodies (RLBs) and ensuring implementation of the HP Panchayati Raj Act, 1994. GoHP annually allocates about Rs. 5 million to RLBs. RLBs also receive a significant amount of funds under Centrally Sponsored Schemes for poverty alleviation and other developmental works. While GPs have power to levy and collect taxes on various accounts, PSs and ZPs do not have such powers and are allocated funds by State Finance Commission.

The following are of note.

- Audit—This is conducted through an audit wing working under the Director, Panchayati Raj. The HP Panchayati Raj Act, 1994 requires that annual audits be conducted of all PRIs; during 2005–06, 50% ZPs, 39% PSs & 55% GPs were audited. The shortfall is reported to be due to elections of the PRIs<sup>131</sup>.

<sup>127</sup> Source: Audit Wing of Urban Development Department.

<sup>128</sup> CAG Civil & Commercial Report 2005.

<sup>129</sup> Para 6.1.8 of CAG Civil & Commercial Report 2005.

<sup>130</sup> Source: Annual Plan 2006–07.

<sup>131</sup> Annual Administrative Report, PRD.



- Inspection provides internal audit function of PRIs. Each PRI should be inspected at least once during a year. During FY 2005–06 around 42% of the GPs were subjected to inspections.
  - Like most other Indian States, HP too faces issues relating to shortage of Panchayat Secretaries as well as low levels of education/training among the existing Panchayat Secretaries.
  - Given the geographical nature of the state, building procurement & financial management capacity at this level can help enhance outcomes.
- that relevant and critical information is consistently available for public scrutiny.
- (e) The benefits of the effectively functioning treasury at the district level need to be rolled-out to cover the entire state; this will be an important step to strengthen internal controls as well as to maintain efficiency of operation in context of the geographical/climatic factors.
  - (f) Accountability of the HoD needs to be more clearly established to ensure more effective and efficient utilization of resources provided to departments.
  - (g) The Local Fund Audit function needs to be consolidated; staff under the ELFA and audit wings of the Urban/Rural Development Departments need to be viewed as a single resource and utilized across the state using a risk based approach.
  - (h) Internal Audit—a small, centralized, skilled internal audit team may be setup to conduct systemic reviews in areas of perceived risks. The process of inspection needs to be systematized.
  - (i) Response to audit needs to be streamlined; this should be supported by a system to track all audit paras, PAC/COPU observations. This would ensure that the state gets the best value out of the audit process rather than seeing it merely as a compliance function.
  - (j) Towards the objective of safeguarding its investments/annual grants and ensuring good governance a one time review of the Financial Management and Procurement Policies of the PSEs may be undertaken; the government may start with the two largest PSEs.

## H. Conclusion: Areas Requiring Priority Attention

- (a) Rules relating to financial management i.e. 'The Himachal Pradesh Financial Rules, 1971' need to be revised to ensure that the framework guiding procurement & financial management are precise, easy to understand and contemporary.
- (b) The state can initiate efforts to ensure that the public procurement system promotes competitiveness through steps that might include application of e-government procurement, and improving the commercial practices of the government.
- (c) Formats/presentation of Budgets and Annual Financial Statements need to be rationalized. These need to be shorter and more easily understandable.
- (d) Regarding **disclosure** in context of the Rights to Information Act, 2005 GoHP may articulate a 'Policy on disclosure of Information' to ensure



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THE WORLD BANK

1818 H Street N.W.  
Washington D.C.  
20433 USA

70 Lodi Estate  
New Delhi 110003  
INDIA

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Karin Kemper  
Sector Manager (SASDN)  
MSN: MC 10-1013

