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Fiscal and Debt Management in Andhra Pradesh (India)

An Update on the Reform Program*

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I. Introduction

1. Andhra Pradesh's development program continues to move forward. The economy is projected to grow at 7.5 percent in 2005-06. The Congress Government, which came to power in May 2004, has put a new emphasis on enhancing the income of the rural poor for a more equitable distribution of economic growth.[1] This emphasis is reflected in the 2006-07 budget which was passed by the AP legislature in March 2006.[2] There is a 25 percent increase in Plan outlay over the last year, and of the Plan expenditure, over 50 percent is allocated for irrigation.[3] Rising spending (particularly for rural infrastructure), the need to generate more resources from less distortionary tax instruments, and the requirement to reduce revenue and fiscal deficits—as mandated by the new Andhra Pradesh Fiscal Responsibility and Budget Management (FRBM) Act of 2005—are some of the new fiscal challenges that the Government of Andhra Pradesh (GoAP) will face in the next few years.

2. The main objective of this fiscal note is to assist the GoAP in meeting the challenges mentioned above. To this end, it provides input into the state's rolling medium-term fiscal framework exercise. The new FRBM act requires that the government will lay out in each financial year a medium-term fiscal policy statement (together with three-year rolling targets for key fiscal indicators) before the state legislature. In addition, this fiscal note provides the needed analytical underpinning for the Bank's ongoing development policy lending program in the state.

3. The remainder of this note is organized as follows. The next section looks at the state's performance in improving its fiscal balance. Section III looks at the revenue performance of the state with a particular emphasis on the newly implemented Value Added Tax (VAT). The size and composition of expenditures is analyzed next (Section IV) with a close examination of the government's new priority expenditure on adding new irrigation schemes. Section V briefly looks at the debt and examines issues related to debt sustainability. Section VI concludes.

II. Improving Fiscal Balance

4. A key component of Andhra Pradesh's (AP) ongoing medium-term reform program involves strengthening fiscal discipline through the preparation of a Medium Term Fiscal Framework (MTFF), and improving the composition of spending by ensuring adequate spending on Operation and Maintenance (O&M) and primary education and health. During the last five years, the successive governments in AP have broadly maintained a prudent fiscal stance. By and large, fiscal performance—relating to both deficit and debt—has been within the range of the Government of Andhra Pradesh's (GoAP) MTFF. Regarding the composition of spending, GoAP has protected O&M spending needs, but progress in raising the share of spending on social sectors has been limited.

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[1] As per the Central Statistical Organization's estimates and the 2005-06 economic survey of AP, over 70 percent of the state's nearly 80 million population lives in rural area and is dependent on income from farming.

[2] "…Having recognized the importance of the agricultural sector for faster economic development, we [have] concentrated largely on its development and [have] introduced several schemes for the benefit of farmers…The fruits of development were not reaching the poorest sections to the desirable extent, due to inequitable distribution of income in spite of high growth rate achieved by the state's economy…" AP's Finance Minister (Budget Speech, February 20, 2006).

[3] 'Plan Outlays' are defined as development projects, programs and schemes in the country's annual plan.

5. In early 2002, the state had prepared a Fiscal Reforms Strategy Paper. Operationalized around a medium-term framework, the strategy projected broad fiscal aggregates over a six-year period, and set annual targets for deficit and debt. This strategy was expected to achieve fiscal stability and make additional funds available for priority development expenditures which were identified as: (i) capital expenditure for new infrastructure creation, (ii) non-salary operations and maintenance (O&M), and (iii) social sector investments in primary health and education.

6. A review of GoAP's fiscal reform program indicates that there has been a commitment in the last several years to achieving aggregate fiscal discipline (Table 1). The fiscal numbers for the last two years were more or less in line with its MTFF targets and the revised estimates for 2005-06 show that the revenue receipts are better than the targets envisaged in the MTFF. The revenue deficit in 2005-06 declined by about 0.8% of GSDP as compared to the previous year 2004-05. Primary and fiscal deficits in 2005-06 also show improvement over the previous year.

Table 1: AP's Fiscal Numbers: MTFF Targets and Achievements

(in Rs crore and as a % of GSDP)

	2004-05		**2005-06**	
	MTFF	**Actuals**	**MTFF**	**RE**
(i) Revenue				
Total Revenue	27368 (13.7)	27143 (13.6)	30951 (13.8)	34194 (15.2)
State's Own Revenue	18636 (9.4)	18431 (9.3)	21035 (9.3)	22777 (10.1)
(ii) Deficit measures				
Primary	-776 (-0.4)	-1101 (-0.6)	174 (0.1)	-1132 (-0.5)
Revenue	-2276 (-1.1)	-2558 (-1.3)	-473 (-0.2)	-1118 (-0.5)
Fiscal	-8374 (-4.2)	-8192 (-4.1)	-8030 (-3.6)	-8190 (-3.6)
Consolidated	-8135 (-4.1)	-9439 (-4.7)	-7765 (-3.5)	-9297 (-4.1)
(iii) Debt measure				
Debt Stock	67395 (33.9)	66393 (34.0)	75009 (33.3)	74533 (33.1)

Definitions:

(i) Primary Surplus (+)/Deficit (-) = Total Revenue – Non-interest Expenditure;

(ii) Revenue Surplus (+)/Deficit (-) = Total Revenue – Revenue Expenditure;

(iii) Fiscal Surplus (+)/Deficit (-) = Total Revenue – Revenue Expenditure – Capital Outlay – Net Lending;

(iv) Consolidated Surplus (+)/Deficit (-) = Fiscal Surplus (+)/Deficit (-) + Gross Budgetary Support to Power Sector – Power Sector Financing Requirement.

Source: AP budget documents. RE = Revised Estimates.

7. GoAP's efforts to practice fiscal discipline have also helped in cash management. Unlike several other states in India, AP has had (and continues to have) a comfortable cash balance position and has not relied on the Reserve Bank's 'Ways and Means Advances' for the past two years. In turn, these efforts have been noted by the Indian financial markets and are reflected in

the successful mobilization of funds through the Reserve Bank of India (RBI) at very low rates of interest.

8. Table 1 also indicates that there is some slippage in the consolidated deficit measure. This measure includes the financial performance of the power sector. One reason is the increasing capital expenditure in the sector which was Rs 2,013 crore in 2005-06, nearly double from Rs 1,012 crore in 2001-02. In view of AP's growing electricity needs, capital expenditure is projected to increase further to Rs 2,696 crore in 2006-07. The other main reason for slippage in the deficit target is the fiscal impact on the budget to accommodate the free power policy to farmers.[4] Excluding the impact of the free power policy to farmers, the level of subsidization fell from 1,513 crore in 2003-04 to Rs 1,380 crore in 2004-05, which reflects continuous progress made by the AP's power companies in better revenue collection and cost reduction (mainly through efficiency enhancements). The free power policy raised electricity subsidies by a further Rs 430 crore to Rs 1,810 crore in 2004-05. Netting out the impact of the free power policy, the overall subsidy to the sector has resumed a declining trend, and is expected to fall to around Rs 1,600 crore in 2005-06.[5]

9. In recent years, GoAP has been able to consolidate its debt and all new borrowings are now fully reflected on budget. It has repaid a significant portion of its off budget borrowings (mainly power sector bonds). Despite these efforts, the debt stock has remained around 33 percent of GSDP (see Section IV below on Debt Management).

10. **The Andhra Pradesh Fiscal Responsibility and Budget Management (FRBM) Act of 2005**. In June 2005, this Act came into force. Among the specific measures, it requires the state government to practice fiscal prudence by (a) progressively eliminating (by 2008-09) revenue deficit with at least 0.32 percent reduction in each year; (b) reducing the fiscal deficit by at least a quarter of one percent of GSDP, to bring it down to no more than 3 percent by the end of 2008-09; (c) constraining outstanding liabilities to no more than 35 percent of GSDP by 2009-10, and (d) limiting the amount of annual incremental risk weighted guarantees to 90 percent of the total revenue receipts of the second preceding year. The base period for these statistics is 2004-05. Through the FRBM, the government has institutionalized its own fiscal reform program with clear milestones for the next four years.

11. **Financial Incentives for Fiscal Prudence: The Twelfth Finance Commission Award.** Fiscal prudence, particularly the progressive reduction of the revenue deficit, is in itself a big reward to the state's economy. Economic research has shown that low and sustainable fiscal deficits are associated with high long-term economic growth. But in the case of AP, as well as for other Indian states, fiscal prudence in the next five years will attract debt write-offs, consolidation and rescheduling from the Government of India (GoI). According to the Twelfth Finance

[4] AP's agriculture sector consumes around 33 percent of the state's electrical energy. Several years of successive droughts in the state led to severe distress and high indebtedness in the farm community. On taking office in May 2004, the new government took two major actions. First, it announced a policy of providing electricity to farmers free of charge, who use it to run pump-sets for irrigation. Second, it took over Rs 1,258 crore worth of electricity dues of farmers. These changes were part of the Congress party's election pledge to provide more government assistance to the rural poor. The free power policy was modified in January 2005 to target the subsidy only to needy farmers. Under the modified policy, farmers who (i) pay corporate and income tax (ii) have land holdings of more than 2.5 acres in wet lands, and (iii) have more than three pump set connections in dry lands, are required to pay for the power supplied.

[5] Increasingly, subsidized household consumption is becoming a major financial burden. During 2005-06, the total subsidies for household power supply stand at about Rs 1,324 crore, comprising of Rs 780 crore of cross subsidy and Rs 544 crore of direct subsidy from GoAP. For more information on the financial performance of the power sector in AP, see the accompanying policy note on the power sector.

Commission (TFC) award for the period 2005-10, GoI loans to states contracted till March 31st 2004 and outstanding as of March 31st 2005, can be consolidated and rescheduled for a fresh term of 20 years at an interest rate of 7.5 percent, which is much lower than the existing rates (ranging from 9.5 to 13 percent). AP stands a chance to get as much as Rs 2,684 crore ($630 million) in interest savings and Rs 740 crore ($173 million) as benefits in repayments over 2005-10. Moreover, if AP is able to reduce its revenue deficit as per the targets, a Rs 3,835 crore ($900 million) debt write-off is available during 2005-10. AP will get Rs 767 crore per year—roughly 2 percent of its projected revenue receipts in 2006-07—if the annual revenue deficit reduction targets are met and revenue surplus is reached by 2008-09. AP has outlined its 'Fiscal Correction Path' as per the requirement of the TFC which is attached in Annex I.

III. Revenue Reform

12. In the area of tax reform, GoAP has continued to take actions to strengthen its revenue performance and improve the state's tax structure. The major reform in 2005 was the implementation of the Value Added Tax (VAT). Moreover, GoAP has acted upon several recommendations of the Revenue Reform Committee (RRC), which had prepared reports on commercial taxes, stamps & registration, excise and motor vehicle taxes.[6]

13. **Implementation of a new tax instrument: The Value Added Tax.** AP, together with 22 other Indian states, implemented a VAT on April 1, 2005. An extensive level of commodity classification has been worked out to determine various rates of taxation. Most agricultural commodities, manually operated agricultural equipment, and goods from allied industries, like marine products, have been exempt from the tax. Jewellery, precious stones and precious metals are taxable at the rate of 1 per cent. The remaining goods are classified in two categories and taxed at the rate of 4 and 12.5 percent respectively. Petroleum products and liquor are subjected to tax at special rates.

14. VAT has improved transparency in taxation and with its less-distortionary structure, has facilitated provision of input tax credit for all eligible purchases. Traders with an annual turnover of less than Rs 500,000 are exempt from registration as VAT dealers. Traders with an annual taxable turnover of more than Rs 500,000 but less than Rs 4,000,000 who have not registered as VAT dealers may pay a flat rate of 1 percent on the taxable turnover. Greater checks by way of written consent of Commissioner Taxes is required for sanction of prosecution under the Act, which would ensure that undue harassment of traders does not take place. Better infrastructure and simpler taxation laws are aimed at better compliance by traders and transparency in decision making by the authorities.

15. Revenue estimates for 2005-06 show that the implementation of VAT has had a positive impact on the collection of taxes and has contributed to a significant increase in the revenue collections. VAT collection exceeded Rs 9,500 crore and has resulted in revenue growth of approximately 14.5 percent between April 2005 and February 2006.

16. **Other revenue**. Following the recommendations of RRC, the state government has rationalized several taxes, which has led to better compliance and collection. The basic rates of stamp duty, transfer duty and registration fees have been rationalized to bring down the rate from

[6] In 2002, the state government established a revenue committee to look at the existing tax and non-tax instruments and make recommendations for reform. The Revenue Reform Committee prepared reports on commercial taxes and stamps & registration.

13.5 to 9.5 percent in urban areas and from 11.5 to 9.5 percent in other areas. The motor vehicles tax has been reduced from 16 to 7.5 percent. Other actions taken on the basis of RRC reports include abolition of internal check posts, establishment of Large Taxpayers Units and Dealer Service Centers in each division, holding of regular bi-monthly meetings with Trade associations to address grievances.

17. The composition of AP's revenue is given in Table 2A and 2B. Overall AP's total revenue –state's own revenue and transfers from GoI—has grown by 1.4 percent of GSDP in 2005-06 over the last year (Table 2A). The share of Andhra Pradesh in the pool of shareable taxes has decreased from 7.7 to 7.4 percent. This is because the weights attached to the criteria—population, income distance, area, tax effort, fiscal discipline and index of infrastructure—of determining the shares of states have been changed. Like all states, AP has gained from the TFC, but overall it has gained less than the other states have, in terms of total central devolution. The share of central taxes increased marginally (0.1 percent of GSDP) whereas the share of central grants increased by about 0.7 percent of GSDP in 2005-06. For the TFC award period, the total transfers from the centre (shared tax revenues and grants-in-aid) to AP are projected to be about Rs 50353 crore.

18. The composition of AP's own tax revenue is given in Table 2B. It shows that the state's own tax revenue in 2005-06 grew by 24 percent over the previous year. The budget estimates for 2006-07 show a lower growth of 18 percent. The main sources of tax revenue – sales tax, state excise and tax on vehicles are budgeted to grow at a lower rate (16 percent) then the growth that was experienced during 2005-06 (28 percent). The lower projected growth for some of the tax revenues is attributed to the lowering and rationalization of tax rates. The state government has been trying hard to augment tax revenues further by systematically strengthening the revenue earning departments and by improving staffing, training and other facilities so as to improve tax compliance. Computerization and Management Information Systems (MIS) have been set up at all revenue earning departments and infrastructure is being strengthened at the field level.

Table 2A: Composition of total revenue

	2004-05 Actuals		**2005-06** RE		**2006-07** BE	
	Rs crore	% of GSDP	Rs crore	% of GSDP	Rs crore	% of GSDP
Total Revenue	27142.7	13.6	34194.0	15.2	41759.5	16.7
Own revenue	18430.9	9.3	22727.3	10.1	26536.3	10.6
Tax	16254.5	8.2	20233.4	9.0	23867.9	9.5
Non-Tax	2176.4	1.1	2494.0	1.1	2668.4	1.1
Transfers from GoI	8711.8	4.4	11466.7	5.1	15223.2	6.1
Shared Taxes	6058.5	3.0	6990.3	3.1	8038.8	3.2
Grants	2653.3	1.3	4476.4	2.0	7184.4	2.9

Source: AP budget documents.

Table 2B: Growth of own tax revenues
(in percent)

	2004-05 Actuals	**2005-06 RE**	**2006-07 BE**
States own Tax Revenue	18	24	18
Direct Taxes	30	33	22

Land Revenue	-3	280	1
Stamps and Registration Fees	25	30	25
Taxes on Immovable Property	-3	416	0
Professional Tax	68	20	15
Indirect Taxes	16	23	17
Sales Tax/VAT	20	15	22
State Excise	9	36	14
Taxes on Vehicles	9	34	14
Taxes & Duties on Electricity	-1	15	5
Other	-56	811	-41

Source: AP budget documents

IV. Level and Composition of Expenditures

19. Total expenditure in 2006-07 is budgeted to increase from 22.0 to 25.3 percent of GSDP over the previous year. This is mainly due to a 25 percent increase in Plan Outlay. Of the latter, 51.1 percent is allocated to the irrigation sector, 28.9 percent to the social sector and 8.7 percent to agriculture and rural development. The total allocation—Plan and Non Plan—for irrigation and flood control has almost doubled from 11.6 in 2004-05 to about 20.3 percent (budgeted) in 2006-07.

20. Table 3 indicates the increasing amount of spending on irrigation related activity. From a little less than 12 percent in 2004-05, the amount as a percent of total spending has gone up to a little over 20 percent in 2006-07. In nominal rupee terms the amount has increased by 140 percent over the two-year period. Table 3 also shows that a big reduction has taken place in the General Services expenditure category. Among social services, education services are now getting a bigger share of the budget.

Table 3: Functional (Sectoral) Composition of Expenditures
(in Rs crore)

	2004-05		2005-06		2006-07	
	Actuals	**% of total**	**RE**	**% of total**	**BE**	**% of total**
Total Expenditure	**45747.10 (22.6)**	**100.0**	**49624.09 (22.0)**	**100.0**	**63527.74 (25.34)**	**100.0**
Economic Services	**13515.46**	**29.5**	**17233.70**	**34.7**	**22830.54**	**35.9**
Agriculture and allied services	1764.29	3.9	1560.28	3.1	1788.14	2.8
Rural Development	1995.82	4.4	2269.27	4.6	3310.55	5.2
Irrigation and flood control	5324.37	11.6	8858.69	17.9	12894.03	20.3
Energy	2086.70	4.6	1712.04	3.5	1536.18	2.4
Others	2344.28	5.1	2833.42	5.7	3301.64	5.2
Social Services	**10863.85**	**23.7**	**13789.25**	**27.8**	**17164.36**	**27.0**
General Education	4361.54	9.5	5993.19	12.1	6693.94	10.5
Medical Services	1492.92	3.3	1776.37	3.6	2113.23	3.3
Urban Development	1134.19	2.5	1498.31	3.0	1847.94	2.9
Others	3875.20	8.5	4521.38	9.1	6509.25	10.2
General Services	**21367.79**	**46.7**	**18601.14**	**37.5**	**23532.84**	**37.0**

Source: AP budget documents. RE – Revised Estimates; BE – Budget Estimates. Numbers in parenthesis are percent of GSDP.

21. **Irrigation infrastructure given priority.** Enhancing rural farm income has been a major theme of the Congress Government in AP. Given that nearly 70 percent of the state's population is dependent on agriculture, it is important for agriculture to do well for economic growth to be broad based and inclusive. By and large, the benefits of high growth in the industrial and service sectors over the past years have not reached the rural poor. With major droughts in the past several years, the government has put a heavy emphasis on building irrigation infrastructure—mainly highly capital intensive surface irrigation projects. In the past two years, construction of 26 major and 17 medium irrigation schemes at an estimated cost of about Rs 70,000 crore (over $16 billion) have been taken up. The plan is to complete these schemes in the next 5 years to bring in about 30 lakh hectares of additional area under irrigation. In the words of AP's Finance Minister "…Irrigation Projects are being executed on war footing." (Budget Speech, February 20, 2006). Most recent estimates suggest that the gross irrigated area in AP has increased from 47.8 lakh hectares in 2003-04 to 49.9 lakh hectares in 2004-05. AP's irrigation sector priorities fit squarely in the irrigation design of the Government of India's "Bharat Nirman Programme" which plans to add 100 lakh hectares of irrigated area in the country.[7]

22. Many other steps, including improving credit facilities for farmers, enactment of a new legislation to strengthen the regulatory mechanism for improving the quality of seeds and fertilizers, distributing surplus government land to poor farmers, are being taken to facilitate higher agricultural growth and enhance the welfare of the rural poor.

23. While investing in productive assets boosts growth, the large irrigation investments carry high risks and therefore, need careful management. The GoAP has already spent on irrigation (and related activities) over Rs 8,000 crore ($1.9 billion or 3.6 percent of GSDP) in 2005-06 and has budgeted Rs over 12,000 crore ($2.8 billion or 4.8 percent of GSDP) in 2006-07. Unless fully completed, the new irrigation projects do not bear any fruits. In this context, the recent experience of Maharashtra is instructive. In 1990s, the Government of Maharashtra (GoM) established an irrigation development corporation called the Maharashtra Krishna Valley Development Corporation (MKVDC), and transferred all works on 35 major, 53 medium and 418 minor projects in the Krishna river valley of the state. For completing this work, MKVDC required Rs 11,660 crore, of which 30 percent was to be paid by GoM and the rest to be raised by MKVDC through sale of state government bonds. During 1996-97 to 2000-01, MKVDC spent nearly Rs 7,000 crore on the irrigation projects to which GoM's contribution was about 20 percent. In the early years of the new century, when the state's fiscal situation started worsening and its credit rating started falling, MKVDC was unable to get subscriptions to its bonds. As a result, projects were not completed on time and the cost soared.

24. The GoM is taking advantage of a GoI scheme—Accelerated Irrigation Benefits Program, a component of the Bharat Nirman Programme—for which the state government will receive resources to complete the irrigation projects. A requirement to access this scheme is that the state should have complete cost recovery of operating and maintaining the systems through irrigation charges. Maharashtra now fully recovers the cost of operations and maintenance (O&M) of its

[7] Launched by the Prime Minister in December 2005, "Bharat Nirman Programme", a four year national development program is aimed at strengthening India's rural infrastructure including irrigation, water supply, housing, roads, telephony and electrification.

irrigation systems through water charges. This, however, remains a problematic issue in AP, where irrigation charges barely cover 30 percent of the O&M costs. Therefore, AP needs to revise its irrigation charges to better recover the O&M cost of not only maintaining its existing systems, but also the newer ones, once they come on line.

25. Irrigation and its potential role in enhancing agricultural income, has become a political and economic imperative in AP, particularly as the growth of manufacturing and services has not spread to the rural poor. In the long-run, however, manufacturing and services are possibly more important for generating jobs and income of those who are currently classified as rural poor. As agriculture productivity increases, more poor rural people will shift to these sectors. Therefore, removing impediments to rural non-farm employment should also be a priority of the state.

26. Table 4 shows the economic composition of spending; two spending items are notable—spending on salaries and pension as part of current expenditure, and capital expenditure are both rising. The big rise in capital spending from Rs 5,414 crore in 2004-05 to a budgeted level of Rs 10,065 crore in 2006-07, is mainly due to the increase in irrigation infrastructure discussed above.

Table 4: Economic Composition of Expenditures

(in Rs crore)

	2004-05		**2005-06**		**2006-07**	
	Actuals	**% of total**	**RE**	**% of total**	**BE**	**% of total**
Total Expenditure	**45747.10 (22.98)**	**100.0**	**49624.09 (22.05)**	**100.0**	**63527.74 (25.34)**	**100.0**
I. Current Expenditure	**31307.34 (15.73)**	**68.4**	**37388.67 (16.61)**	**75.3**	**45327.01 (18.08)**	**71.3**
Salaries and Pensions	11842.09 (5.95)	25.9	14836.76 (6.59)	29.9	15992.08 (6.38)	25.2
Transfers & Subsidies	6845.79 (3.44)	15.0	8676.73 (3.86)	17.5	12631.85 (5.04)	19.9
Interest Payments	7091.41 (3.56)	15.5	7058.04 (3.14)	14.2	7983.18 (3.18)	12.6
Non-salary O&M	3823.66 (1.92)	8.4	4110.28 (1.83)	8.3	4806.78 (1.92)	7.6
Others	1704.39 (0.86)	3.7	2706.86 (1.20)	5.5	3913.12 (1.56)	6.2
II. Capital Expenditure	**5414.23 (2.72)**	**11.8**	**7223.17 (3.21)**	**14.6**	**10065.35 (4.02)**	**15.8**
III. Loans & Advances	**1593.14 (0.80)**	**3.5**	**1006.30 (0.45)**	**2.0**	**1308.23 (0.52)**	**2.1**
IV. Capital Disbursements	**7432.39 (3.73)**	**16.2**	**4005.94 (1.78)**	**8.1**	**6827.16 (2.72)**	**10.7**

Source: AP budget documents. RE – Revised Estimates; BE – Budget Estimates. Numbers in parenthesis are percent of GSDP.

27. **Expanding wages and salaries.** Salaries and pensions have risen by 25 percent (in absolute terms) in 2005-06 and are budgeted to increase by another 8 percent in 2006-07. The first increase was due to the recommendations of the AP's Sixth Pay Revision Commission

(PRC) 2005, which submitted its findings in June 2005.[8] Starting July 1, 2005 all state government officials and pensioners were given an average increase of 16 percent in compensation. The estimated annual expenditure on account of the recommendations of PRC was close to Rs 2,000 crore. The Twelfth Finance Commission has recommended that states follow a recruitment and wage policy in such a manner that the total salary bill relative to revenue expenditure net of interest payments and pensions should be below 35 percent. The ratio as per the budget estimates of 2006-07 is 39 percent.

28. Civil service pensions have doubled between fiscal years 1996-97 and 2000-01. By 2004-05, pensions consumed around 14 percent of own revenues and were equivalent to about one third of the total wage bill. These figures were calculated prior to the most recent State Pay Commission and are now undoubtedly higher due to the wage and pension increase. As there is no fund backing future pension promises, there is an unfunded (and unreported) pension liability in the range of one quarter of GSDP.[9] In order to reduce this liability and eliminate certain inequities inherent in the defined benefit formula, the GoAP is considering parametric reforms ranging from changing the earnings base of the pension calculation to revision of the commutation factors towards actuarial fairness. Meanwhile, new entrants are now covered in a defined contribution scheme, although the scheme has not been fully implemented.

29. In 1999, almost all Indian states had a major negative impact on their finances resulting from the big wage increase (nearly 30 percent) that followed the National Fifth Pay Commission. AP has already had another big increase in 2005-06. Together with this increase and the accompanied increase in transfers and subsidies (see below), the current expenditure has gone up by 2.3 percent of GSDP in the last two years. In this context, AP faces two challenges. First, with big increases in both current and capital expenditures, will it be able to meet its own fiscal targets as per the FRBM Act? Second, will the big rise in rural infrastructure spending be managed well to ensure that it has the desirable (and stated) growth effects?

30. **Subsidies and transfers**. A big jump in subsidies and transfers is budgeted for 2006-07. The budgeted amount is more than 1 percent of GSDP over the previous year. During 2006-07 the social pension (to all eligible old aged, widows and handicapped) is to be increased from Rs 100 to Rs 125 per month and the benefit extended to 8.47 lakh new beneficiaries under the "Indiramma Program". For the year 2006-07, approximately Rs 445 crore has been allotted towards these pension schemes. At the behest of the GoI, it is likely that the social pension amount may go up to Rs 200 per month. While subsidies to the power sector is expected to decline—from Rs 1620 crore in 2005-06 to Rs 1430 crore in 2006-07—the rice subsidy is budgeted to increase from Rs 550 crore to Rs 720 crore over the same period. As in the past, the latter scheme continues to provide subsidized rice to a lot more people than those who are truly below the poverty line.

31. In consonance with the National Rural Employment Guarantee Act 2005, the state government established the Andhra Pradesh Rural Employment Guarantee Scheme. This scheme is being implemented in thirteen districts in the state with an indicative outlay of Rs 900 crore. Funds under this scheme would be shared by the central and state governments in the ratio 90:10. As per this scheme, the government is committed to providing work for at least 100 days a year for one person in every household registered under this Act. If for any reason the government

[8] The last Pay Revision Commission in AP was setup in 1999, which led to a major revision of pay scales of civil servants.

[9] This figure depends on various assumptions about the future size of government, future wage increases, life expectancies and the discount rate among others.

fails to do so within 15 days from the date of request, an unemployment allowance will be paid which is equal for both men and women.

32. **Other current spending**. As discussed earlier, AP has already benefited from debt swaps and consolidation in the range of Rs 550 crore in 2005-06. If it continues to manage its finances well, it will gain further interest reduction and possible debt write-offs from the GoI. Non-wage operations and maintenance have remained at a level of around 1.9 percent of GSDP but has shown a growth of 17% from last year.

V. Debt Management

33. Indian states face several restrictions on public borrowing: they cannot borrow externally, and as long as they have any loans outstanding from the Government of India, they cannot borrow domestically without the concurrence of the central government. Typically, the public debt of a state consists of (i) domestic market borrowings (loans from banks and financial institutions); (ii) loans from the central government (State plan Schemes, Central Plan Schemes, Ways and Means advances from the Reserve Bank) and (iii) National Small Savings collection in the state given by GoI as loans and provident funds.

34. Table 5 below gives the composition of public debt of Andhra Pradesh. In the past few years, open market borrowings have emerged as the cheapest source of funds for state governments, since the interest rates on them have declined continuously from around 14 percent in 1998-99 to approximately 6 percent in 2003-04. However, central government loans remain the largest component of the AP's public debt, in part because the GoI regulates the open market borrowings for states. The central government loans were typically market loans raised by the GoI at the prevailing interest rates and on-lent to the states at higher rates (as high as 9.5-10 percent in 2003-04). As seen from Table 5, this has been one of the main components of debt of Andhra Pradesh. As per the Twelfth Finance Commission's recommendation—accepted by the GoI—the central government is not to provide any loans to the states, which may access the markets directly in order to meet their borrowing requirements.

Table 5: Public Debt of Andhra Pradesh: Stock and Composition

(in Rs crore and as a percent of total)

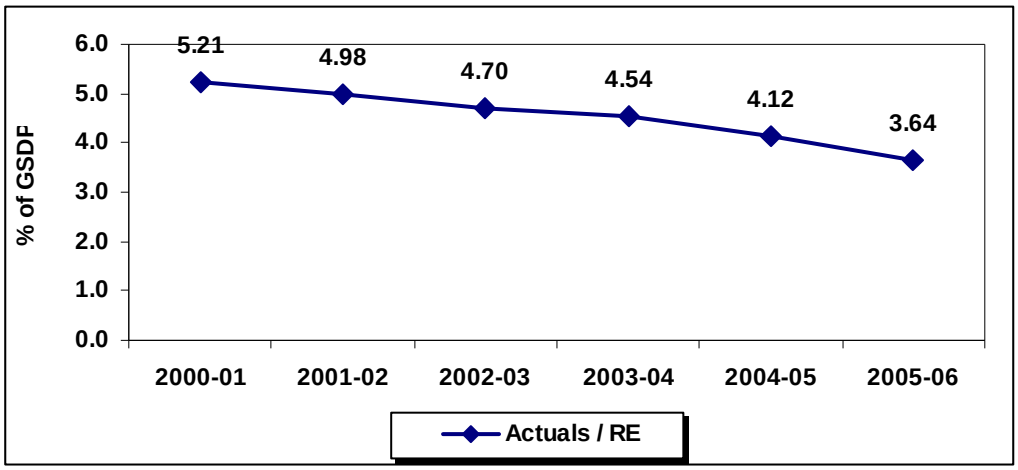
	2001-02	**2002-03**	**2003-04**	**2004-05**	**2005-06 RE**	**2006-07 BE**
I. Open Market Loans	11038.9 (26.0)	14259.1 (28.5)	17085.9 (29.1)	19965.5 (30.1)	21348.1 (28.6)	22730.6 (27.5)
II. Loans from Central Govt	19032.9 (44.8)	19288.9 (38.5)	18706.4 (31.8)	16129.2 (24.3)	16701.2 (22.4)	17883.1 (21.6)
III. Loans from Autonomous bodies	4590.3 (10.8)	5632.3 (11.3)	8089.8 (13.8)	10187.8 (15.3)	11236.5 (15.1)	11192.5 (13.5)
IV. Small Savings & Provident Fund	7830.3 (18.4)	10903.1 (21.8)	14888.2 (25.3)	20110.7 (30.1)	25247.2 (33.9)	30913.7 (37.4)
Total Public Debt Outstanding (I+II+III+IV)						
In Rs crore	**42492.3**	**50083.3**	**58770.3**	**66393.2**	**74533.0**	**82720.0**

As a % of GSDP	**28.1**	**30.7**	**31.9**	**33.3**	**33.1**	**33.0**

Source: AP budget documents. RE – Revised Estimates; BE – Budget Estimates. Numbers in parenthesis are percent of GSDP.

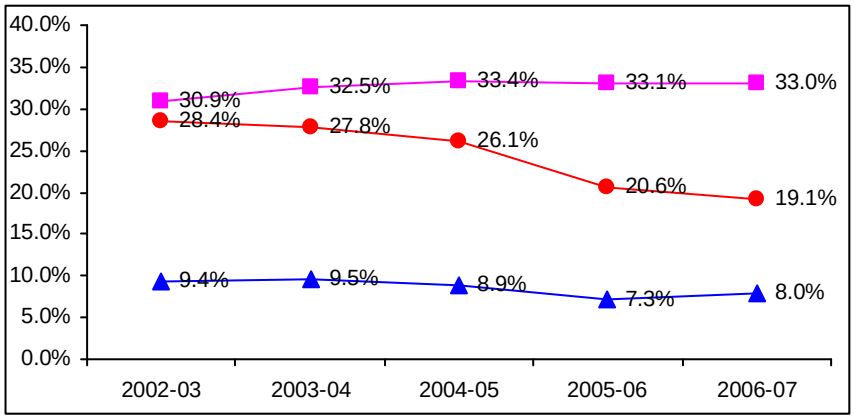
35. A debt swap scheme was introduced in September 2002 by the GoI to provide some relief for the high cost debt owed by states to the central government. This enabled states to retire some of their high cost debt (with interest rate as high as 13 percent) by swapping with low cost borrowings. By the end of March, 2005, AP had used this facility to swap about Rs 13,470 crore of its 'high cost debt' (loans with interest rates of 13 percent and over) and substituted it with cheaper open market loans and small savings loans at interest rates ranging from 6.5 to 10.5 percent. This has allowed them an overall debt relief of Rs 550 crore.

Figure 1: Fiscal Deficit – Progress over Time



36. Persistent fiscal deficits over the years (Figure 1) have led to a steady rise of debt stocks from the equivalent of 28 percent of GSDP in 2001-02 to around 33 percent in 2006-07 (Table 5). Concerned with the issue of debt sustainability in states, the Eleventh Finance Commission had defined a state to be 'debt stressed' if the ratio of its interest payments to revenue receipts exceeds 20 percent. AP has been successful in bringing down this ratio from 28.4 percent in 2002-03 to 20.6 percent in 2005-06. (See Figure 2 below). While this still puts AP as a 'debt stressed' state, the budget estimates for 2006-07 put this ratio at 19.1 percent. The Twelfth Finance Commission has recommended reducing this ratio further to 15 percent.

Figure 2: AP's Debt and Guarantees



policymakers who are in the process of investing in big infrastructure projects in the next few years.

VI. Conclusion

38. Andhra Pradesh continues to make progress in expanding its economy and improving the welfare of its citizens. In the last two years—which are the first two years of the Congress government—there has been a renewed emphasis on enhancing rural income. Agriculture, which is the main source of income for 70 percent of the population, is seeing a huge increase in public resources. New irrigation projects are being commissioned, a majority of farmers are receiving free power for their irrigation pump sets, the quality of other farm inputs (such as seeds) is being improved, surplus public land is being distributed to the poor, and improved credit facilities are being provided to farmers. With proper governance and execution of these programs, they could help the farm sector grow at a 4 to 5 percent rate, which in turn would allow the rural poor to share more of the benefits of AP's progress. With continued high growth in the manufacturing and services sectors, the AP economy could grow by more than 8 percent over the next several years.

39. Big infrastructure investments, such as the one AP has been contemplating in irrigation, are risky, but could also yield high returns. The GoAP should be mindful of the recent Mahrashtran experience with a similar initiative. One of the main reasons for the difficulties faced by Maharashtra was the state's inappropriate fiscal management, which led to a sharp reduction in the state's budget allocations to the irrigation projects. AP has already charted out its fiscal plan and has institutionalized it through the FRBM Act. The state also stands to gain significant resources from the central government if it continues on the stated fiscal path.

40. Only the future will tell whether AP is able to withstand the challenges of its fiscal restraint and succeed in its development objectives. It has taken a few bold steps including passing the FRBM Act and strengthening measures underpinning fiscal discipline. Successful VAT implementation is a laudable step. Limiting pressure from the wage bill over the next few years will be important. A real challenge for the GoAP lies in resisting populist pressures, managing finances well, and continuing to move forward on its well laid out development agenda.

Annex I

AP's Fiscal Correction Path: Outcome Indicators (in Rs crore)								
	Particulars	**Base Year (2004-05 RE)**	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**	**2009-10**
A. STATE REVENUE ACCOUNT								
1	Own Tax Revenues	17311.09	16254.5	19783.35	23440.26	26737.53	30507.24	34817.72
	as % of GSDP		8.17	8.79	9.35	9.56	9.75	9.94
2	Own Non-Tax Revenue	4279.70	3755.57	4559.90	4801.53	5158.41	5544.81	6038.38
3	**Own Tax & Non-Tax Revenue (1+2)**	**21590.79**	**20010.07**	**24343.25**	**28241.79**	**31895.94**	**36052.05**	**40856.10**
4	Share in Central Taxes & Duties	6336.50	6058.51	6990.29	7690.29	8459.32	9305.25	10235.78
5	Plan Grants	3443.41	2222.45	1609.06	2158.03	1834.37	1929.34	1898.81
6	Non-Plan Grants	623.13	458.47	1222.56	1326.59	1140.62	1155.35	1170.83
7	**Total Central Transfers (4 to 6)**	10403.04	8739.43	9821.91	11174.91	11434.31	12389.94	13305.42
8	**Total Revenue Receipts (3+7)**	**31993.83**	**28749.5**	**34165.16**	**39416.7**	**43330.25**	**48441.99**	**54161.52**
	as % of GSDP		*14.44*	*15.8*	*15.72*	*15.49*	*15.49*	*15.46*
9	Plan Expenditure	8875.46	6735.08	7136.86	8678.67	9612.51	11266.85	13521.15
	as % of GSDP		*3.38*	*3.17*	*3.46*	*3.44*	*3.6*	*3.66*
10	Non-Plan Expenditure	24580.01	24572.26	28728.30	31891.13	34329.92	37085.14	40140.37
	as % of GSDP		*12.34*	*12.77*	*12.72*	*12.27*	*11.86*	*11.46*
11	Salary Expenditure	8475.61	8097.64	9684.21	9877.89	10075.45	10276.96	10482.50
12	Pension	2770.78	3016.77	3307.85	3834.03	4217.43	4639.17	5103.09
13	Interest Payment	7228.22	7091.41	7128.78	7752.39	8643.78	9500.63	10355.97
14	Subsidies – General	2035.19	2163.68	1591.67	1671.25	1754.82	1842.56	1934.68
15	Subsidies – Power	1820.86**	1811.45**	1672.77	1599.48	1599.48	1599.48	1599.48
16	**Total Revenue Expenditure (9+10)**	**33455.47**	**31307.34**	**35865.16**	**40569.8**	**43942.43**	**48351.99**	**53661.52**
	as % of GSDP		*15.73*	*15.94*	*16.18*	*15.71*	*15.46*	*15.32*
17	Salary + Interest + pensions (11+12+13)	18474.61	18205.82	20120.84	21464.31	22936.66	24416.76	25941.56
18	as % of Revenue Receipts (17/8)	57.74	63.33	58.89	54.45	52.93	50.40	47.9
19	**Revenue Surplus/Deficit (8+16)**	**-1461.64**	**-2557.84**	**-1700.00**	**-1153.10**	**-612.18**	**90.00**	**500.00**
	as % of GSDP		**-1.28**	**-0.76**	**-0.46**	**-0.22**	**0.03**	**0.14**
B. CONSOLIDATED REVENUE ACCOUNT								
1	Power sector loss/profit net of actual subsidy transfer		57.00	116.00	121.00	125.00	130.00	135.00
2	Increase in debtors during the year in power utility accounts (increase (-))							
3	Interest payment on off-budget borrowings and SPV borrowings made by PSU/SPUs outside budget							
4	Total (1 to 3)	0.00	57.00	116.00	121.00	125.00	130.00	135.00
5	Consolidated Revenue Deficit (A19+B4)	-1461.64	-2500.84	-1584.00	-1032.10	-487.18	220.00	635.00
C. CONSOLIDATED DEBT								
1	Outstanding Debt and Utility	66202.86	71427.05	79557.36	87738.21	95920.29	104085.7	112185.97
2	Total outstanding guarantee	17231.94	17508.30	19087.80	20042.19	21044.30	22096.51	23201.34
	of which							
	Guarantee on account of-budgeted borrowing and SPV borrowing		2300.60	2356.61	2238.78	2126.84	2020.50	1919.47
D. CAPITAL ACCOUNT								
1	Capital Outlay	5880.22	5414.23	6937.69	7620.26	7988.47	8620.34	9309.97

	as % of GSDP		*2.72*	*3.08*	*3.04*	*2.86*	*2.76*	*2.66*
2	Disbursement of Loan and Advances	845.68	1593.14	1123.27	1234.66	1321.32	1448.93	1159.59
3	Recovery of Loans and Advances	1480.66	1372.98	1757.4	1127.17	1139.89	1153.88	1169.27
4	Other Capital Receipts				700.00	700.00	700.00	700.00
5	**Gross Fiscal Deficit (GFD)***	**-6706.88**	**-8192.23**	**-8003.56**	**-8180.85**	**-8082.08**	**-8125.39**	**-8100.29**
	as % of GSDP		**-4.12**	**-3.56**	**-3.26**	**-2.89**	**-2.6**	**-2.31**
	GSDP (Rs. In Crores) at Current Prices	**199075**	**199075**	**225054**	**250674**	**279732**	**312741**	**350295**
	Actual/Assumed Nominal Growth Rate (%)		*10.10*	*13.05*	*11.38*	*11.59*	*11.8*	*12.01*

Notes: * GFD as per para 19 of the guidelines; ** Included in Plan Expenditure