ADB

Report and Recommendation of the President to the Board of Directors

Project Number: 45288-002
October 2014

Proposed Policy-Based Loan and Technical Assistance Grant
India: Punjab Development Finance Program

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 17 September 2014)

Currency unit	–	Indian rupee/s (Re/Rs)
Re1.00	=	$0.01639
$1.00	=	Rs61.000

ABBREVIATIONS

ADB	–	Asian Development Bank
FPMU	–	fiscal policy and management unit
GOP	–	Government of Punjab
GSDP	–	gross state domestic product
LIBOR	–	London interbank offered rate
MTEF	–	medium-term expenditure framework
MTFF	–	medium-term fiscal framework
PSPCL	–	Punjab State Power Corporation Limited
TA	–	technical assistance

NOTES

(i) The fiscal year (FY) of the Government of India and its agencies begins on 1 April and ends on 31 March. FY before a calendar year denotes the year in which the fiscal year starts, e.g., FY2011 begins on 1 April 2011 and ends on 31 March 2012.

(ii) In this report, "$" refers to US dollars.

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PROGRAM AT A GLANCE

1. Basic Data			Project Number: 45288-002
Project Name	Punjab Development Finance Program	Department /Division	SARD/SAPF
Country	India	Executing Agency	Finance Department, Government of Punjab
Borrower	India		

2. Sector	Subsector(s)	ADB Financing ($ million)
✓ Public sector management	Public expenditure and fiscal management	200.40
	Total	200.40

3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	Climate Change impact on the Project	Medium
Environmentally sustainable growth (ESG)	Eco-efficiency Natural resources conservation		

4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD)	Public financial governance	Some gender elements (SGE)	✓
Knowledge solutions (KNS)	Application and use of new knowledge solutions in key operational areas		

5. Poverty Targeting		Location Impact	
Project directly targets poverty	No	Rural	High
		Urban	Medium

6. **Risk Categorization:** Complex

7. **Safeguard Categorization** **Environment:** C **Involuntary Resettlement:** C **Indigenous Peoples:** C

8. **Financing**

Modality and Sources	Amount ($ million)
ADB	**200.40**
Sovereign Capacity development technical assistance: Technical Assistance Special Fund	0.40
Sovereign Program loan: Ordinary capital resources	200.00
Cofinancing	**0.00**
None	0.00
Counterpart	**0.00**
None	0.00
Total	200.40

9. **Effective Development Cooperation**

Use of country procurement systems	Yes
Use of country public financial management systems	Yes

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based loan to India for the Punjab Development Finance Program. The report also describes proposed technical assistance (TA) for Supporting the Punjab Development Finance Program, and if the Board approves the proposed loan, I, acting under the authority delegated to me by the Board, approve the TA.[1]

2. The program seeks to facilitate implementation of a comprehensive fiscal consolidation program in Punjab. This will generate fiscal savings and make better use of scarce budgetary resources, and thereby help with socioeconomic development of the state.[2]

II. THE PROGRAM

A. Rationale

3. **Current economic status.** Punjab is primarily an agrarian economy with a population of 28 million. It has been instrumental in ensuring national food security since the 1960s following the advent of the green revolution. The state government traditionally provides subsidies, including free power to farmers to promote agriculture, which is constrained by declining productivity, soil degradation, and water depletion.[3] This has many ramifications. Punjab's ranking in per capita income in India declined from fourth in FY2004 to seventh in FY2012. Gross state domestic product (GSDP) growth was 6% during FY2002–FY2006 compared with 7.6% for the country, and 6.5% during FY2007–FY2012 compared with 7.5% for the country.

4. **Large committed expenditures.** Despite relatively robust own-tax effort with an own-tax to GSDP ratio of 8.3% in FY2012 (Table 1), the deteriorating fiscal situation has placed added pressures on public resources, constraining capital investment and leading to low growth and poor delivery of public goods and services in the state.[4] The committed expenditures of the state government (salaries, pensions, interest payments, and subsidies) have almost exhausted the total revenue receipts in recent years, requiring the state to undertake even larger borrowing to finance these expenditures in addition to capital expenditure, thereby trapping the state in a vicious cycle of mounting current account (revenue) and fiscal deficits.[5] The weak financial performance of public sector enterprises, including the newly created Punjab State Power Corporation Limited (PSPCL) and Punjab State Transmission Corporation Limited, has

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1 The design and monitoring framework is in Appendix 1.

2 The Asian Development Bank (ADB) provided project preparatory technical assistance, approved by the director general of the South Asia Department on 22 November 2012 for an amount not exceeding the equivalent of $220,000, as a subproject under the cluster TA (ADB. 2009. *Technical Assistance Cluster to India for Advanced Project Preparedness for Poverty Reduction.* Manila [C-TA 0003-IND, financed by the Government of the United Kingdom through the Department for International Development]).

3 The primary sector contributed more than 57% to GSDP in FY1970, followed by the tertiary sector (27%) and the secondary sector (16%), but the contribution to GSDP originating from the primary sector declined to nearly 47% in FY1990 and 21.8% in FY2012.

4 The Government of Punjab (GOP) fails to provide matching grants to several centrally sponsored schemes in such areas as rural housing and rural livelihood. Consequently, the national government does not transfer all the project funds originally approved.

5 The debt stock–GSDP ratio for FY2012 will be much higher than 31.7% if off-budget items and contingent liabilities are included. Moreover, Punjab has accessed ways and means advances from the Reserve Bank of India for highest number of days across Indian states since FY2010.

exacerbated the growing fiscal imbalances and mounting public debt.[6]

Table 1: Key Fiscal Indicators across Selected States in India (FY2012)
(all variables are percentage of gross state domestic product)

Item	Punjab	GCS Average	Haryana	Uttar Pradesh	Best Performing
Own tax	8.3	7.7	6.9	7.9	10.2 (Karnataka)
Revenue deficit	1.6	0.0	0.9	(0.7)	(2.6) (Jharkhand)
Fiscal deficit	3.2	2.6	2.3	2.8	1.1 (Odisha)
Debt	31.7	24.4	18.6	33.7	12.5 (Chattisgarh)
Capital outlay	1.5	2.4	1.3	3.4	4.6 (Bihar)

( ) = revenue surplus, GCS = general category states.
Note: Punjab is a general category state. States are divided into general category and special category based on geographic terrain and inherent infrastructure difficulties. Revised estimates for fiscal variables have been used to facilitate comparisons across states. However, actuals for Punjab for FY2012 are available. Actual figures, as a percentage of gross state domestic product, are own-tax revenue (7.9), revenue deficit (2.6), and fiscal deficit (3.3).
Source: Reserve Bank of India report on state finances, a study of state budgets, 2013–2014.

5. **Limited fiscal flexibility.** Punjab's fragile fiscal situation could also be attributed to ad hoc expenditure planning and management with untargeted transfer payment and subsidy schemes. Moreover, the lack of an evaluation and monitoring system causes inordinate delays in project execution leading to cost escalation, and projects quite often fail to deliver desired outcomes. More importantly, the untargeted power subsidy and, in particular, free power to farmers, has brought both the state exchequer and the power sector to the brink of financial collapse.[7] The share of the subsidy in total revenue (current) expenditure was 12.8% (1.8% of GSDP) in FY2012.[8] This has many implications. First, PSPCL is unable to modernize power infrastructure due to the lack of borrowing opportunities from banks and financial institutions.[9] Second, the deteriorating fiscal situation of the Government of Punjab (GOP) has had negative consequences for its development agenda. In particular, the increase in nondiscretionary committed expenditure has limited the government's ability to make effective use of public spending to meet its policy priorities. More directly, this has resulted in a large opportunity cost as a disproportionate share of the fiscal adjustment fell on capital spending. Capital outlay (capital investment) as a percentage of GSDP remains lower than the general category state average (Table 1).

6. **Unsustainable development paradigm due to power subsidies.** Despite GOP's efforts to reduce input cost through various subsidies including free power to farmers, Punjab's agriculture is currently facing serious challenges. Moreover, power subsidies have led to an unsustainable development paradigm without matching growth in food-grain yields. Indeed, high

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[6] Power reforms—other than notional unbundling of the Punjab State Electricity Board—need to be expedited to meet the power needs of all sectors as well as household consumption requirements.

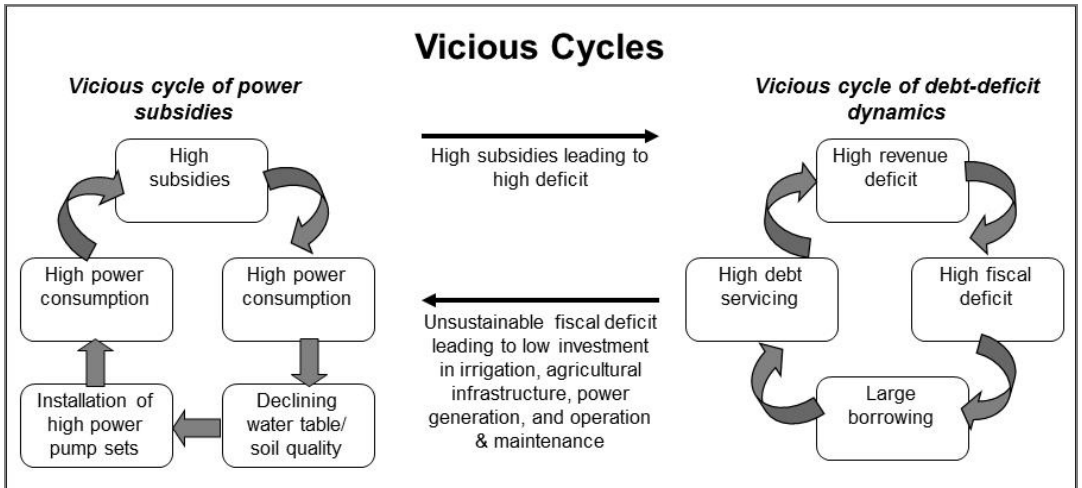
[7] In several instances, the state exchequer has been unable to make cash transfers to the electricity boards because of hard budget constraints. Only notional book adjustments are made. This, however, aggravates the problems of the electricity boards because they have to pay for power purchases. R. Kaur and M. Sharma. 2012. Agricultural Subsidies in India: Case Study of Electricity Subsidy in Punjab State. *International Journal of Scientific and Research Publication*. 2 (10).

[8] Moreover, at an average of 1.6% of GSDP during FY2007–FY2012, power subsidies account for a disproportional amount of the total implicit subsidies. Sector Assessment: Public Sector Management (accessible from the list of linked documents in Appendix 2).

[9] This has other ramifications. For example, public sector banks are currently struggling with nonperforming assets originating from bad loans to the state electricity boards and state power corporations. Consequently, public sector banks are reluctant to lend to these electricity boards and/or corporations.

power subsidies have led to overconsumption of water, resulting in a reduction of underground water reserves as the water table declines, necessitating the use of higher capacity pump sets, which, in turn, consume more power and result in higher power subsidies.[10]

7. **Major policy challenges.** Punjab is caught in two vicious cycles of power subsidies and debt–deficit dynamics, reinforcing each other, and undermining fiscal and environmental sustainability.



Source: Asian Development Bank.

8. **Creating fiscal space.** The logic of the program hinges on the link between creating fiscal space as a means to augment and sustain capital investment in the state and laying the groundwork for improvements in investment in economic and social infrastructure. However, this will require initiating simultaneous and incremental reforms in state finances and free power supply to agriculture.[11]

9. The program is consistent with the country partnership strategy (2013–2017) for India, which states that the Asian Development Bank (ADB) will continue to provide assistance for fiscal consolidation in the states to facilitate reorientation of public expenditure in favor of capital investment.[12] [13]

10. Based on a comprehensive diagnostic study (footnote 2), the program specifies three areas for support in setting state finances on a path consistent with a revised and sustainable

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[10] Within the state, 79% of the groundwater assessment divisions (blocks) are now considered overexploited and critical with extraction exceeding supply. From 1982 to 1987, the water table in Central Punjab fell at an average of 18 centimeters per year. That rate of decline accelerated to 42 centimeters/year during 1997–2002, and to a staggering 75 centimeters during 2002–2006. Water tables are now receding in about 90% of the state, with Central Punjab most severely affected (http://water.columbia.edu/research-projects/india/punjab-india/). Moreover, reduced surface water availability during the summer months due to climate change will have a serious impact on agriculture. Adequate groundwater can be of great help in mitigating this effect (Asian Development Bank. 2012. *Economics of Reducing Greenhouse Gas Emissions in South Asia*. Manila). Thus, the program will facilitate climate change mitigation.

[11] Direct and indirect subsidies and underpriced tariffs are important policy barriers for promoting renewable energy-based power (Asian Development Bank. 2012. *Economics of Reducing Greenhouse Gas Emissions in South Asia*. Manila).

[12] ADB. 2013. *Country Partnership Strategy: India, 2013–2017.* Manila.

[13] The program is also consistent with ADB's assistance program for the energy sector.

medium-term fiscal framework (MTFF). Capacity building and institutional strengthening under the attached TA will be critical to eliminating the constraints of the state. Sound business processes cannot be implemented and maintained unless capacity development is an integral part of new initiatives. The program areas include the following:

(i) **Fiscal management.** Rationalization of public expenditure to better support growth and human development essentially improves the allocative efficiency of scarce public resources. Medium-term expenditure frameworks (MTEFs) could play an important role in strengthening budget and expenditure management through better utilization of fiscal resources, in line with priorities of GOP. Thus, MTEFs for the line departments, combined with a top–down MTFF, are the prerequisites for effectively rationalizing public expenditure. However, an effective MTEF requires both a long-term sector strategy and a system of project appraisal and evaluation. MTEFs cannot be implemented rigorously unless supported by these two tools.

(ii) **Expenditure rationalization focusing on power subsidy.** Given political sensitivities, rationalization of the agriculture power subsidy and improvement of the targeting of power subsidies need to be implemented in a phased and incremental manner. This requires changing behavior by introducing demand management incentives supported by a public awareness campaign. Free power to farmers will continue. However, this will be capped based on normative power supply requirements.[14] Demand-side measures will provide incentives to farmers to contain power consumption below the normative requirements. The crop-specific and region-specific thresholds for power consumption in agriculture will be worked out during program implementation and supported by the TA. The relevant policy action could be introduced by the second tranche of the program. The GOP has prepared a strategy to improve the targeting of power subsidies, which includes measures to encourage reducing power consumption to below the normative requirements. Finally, supply-side measures are important to improve the efficiency of the power supply through improved technical performance of PSPCL. This, in turn, will improve the finances of PSPCL, and the general state budget.

(iii) **Revenue reforms.** One important prerequisite of fiscal consolidation is that state finances are augmented, to the extent possible, by own-revenue sources. Reforming the revenue streams is critical for augmenting own-revenue sources. The program focuses on improving state revenue efforts by rationalizing tax rates and thresholds of certain taxes, and introducing a new tax. These reforms will enable GOP to mobilize more own-tax revenue from the revenue base.

11. **Lessons.** Punjab is one of the three states in India currently in an extremely poor fiscal situation and, therefore, requires immediate assistance for fiscal consolidation. In October 2012, the ADB Board of Directors approved a similar loan for the state of West Bengal.[15] During processing, the program drew on lessons from all previous loans, including the West Bengal

[14] Normative power requirements imply maximum quantum of free power allowed for a consumer category. It will be established on the basis of a detailed study of geographical region, rainfall, cropping pattern, and water table depths.

[15] ADB. 2012. *Report and Recommendation of the President to the Board of Directors: Proposed Policy-based Loan and Technical Assistance Grant to India for the West Bengal Development Finance Program.* Manila (Loan 2926–IND, approved on 30 October).

loan. This is a continuous process to improve the program design for greater aid effectiveness.[16] Three critical lessons are that (i) state government ownership to implement sensitive reforms is extremely critical, (ii) capacity development support is essential during implementation, and (iii) active stakeholder consultation including a communication strategy can mitigate the risk of nonparticipation by stakeholders and address vested interests that may risk the reform momentum. For this program, stakeholder consultations with industries, academics, and the association of industries have been carried out and will continue throughout implementation.

B. Impact and Outcome

12. The impact will be improved capital investment in the state. The outcome will be a larger and more sustainable fiscal space in the state government.

C. Outputs

13. ADB and the GOP reached an agreement on the broad areas of ADB support under the fast-disbursing policy reform program:

(i) **Improved capacity for fiscal management.** Reform measures will include (a) designing fiscal responsibility and budget management rules; (b) establishing a fiscal policy and management unit (FPMU) in the state Finance Department to carry out project appraisal, monitoring, and evaluation to improve allocation of public expenditures based on certain principles; (c) preparing long-term sector strategies in selected departments along with road maps for achievement of goals; and (d) preparing a departmental rolling MTEF for selected departments. The program will strengthen the state's cash management system to ease borrowing requirements and enhance institutional capacity to actively manage state debt. All of these measures will serve to generate fiscal savings, which in turn will support gradual increases in the capital outlay to GSDP ratio proposed under the program.

(ii) **Rationalized expenditure focusing on power subsidies.** Power subsidy rationalization (or improved targeting of power subsidies) will include (a) introducing normative free power requirements for agriculture and incentivizing efficient uses of power,[17] (b) segregating agriculture feeder lines and using the agriculture feeder data for subsidy calculation, (c) introducing 100% feeder metering, (d) introducing distribution meters, (e) introducing a system of power demand forecasting and management, and (f) implementing a debt restructuring plan for PSPCL.

(iii) **Improved revenue efforts.** Revenue efforts will be strengthened by (a) introducing a profession tax, (b) reducing the threshold for tax deducted at the source on works contracts, (c) increasing the tax rate on turnover to a comparable level of other states, and (d) digitizing land records.[18]

14. There are 22 policy actions proposed in the program distributed over three tranches (8

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[16] For example: (i) ADB. 2007. *Special Evaluation Study: ADB Support to Public Resource Management in India.* Manila; (ii) M. Attinasi and B. Carrasco. 2008. *Public Resource Management Reform Programs: Do They Work?* Manila: ADB; and (iii) A. Mukherji and H. Mukhopadhyay. 2011. Evaluating the PRMPA Using a Synthetic Control Group. *South Asia Working Paper Series.* No. 2. Manila: ADB.

[17] Details of alternative plans are incorporated in the strategy paper for improved targeting of agricultural power subsidies.

[18] Digitization of land records will facilitate better compliance with stamp duty and registration fees.

policy actions in the first tranche, 7 policy actions in the second tranche, and 7 policy actions in the third tranche) Greater investment in economic and social infrastructure is an important prerequisite for sustaining high growth and employment. Without high growth, especially manufacturing growth, the commercial state tax base will not grow commensurately with the capital investment needs of the state. Thus, the program's focus on higher capital investment will have an indirect impact on revenue mobilization and fiscal space creation, in addition to the direct impact channeled through the program outputs.

D. Development Financing Needs

15. Keeping the fiscal deficit at a sustainable level will be difficult for GOP unless it continues to reduce development expenditure, despite the negative impact on growth and development. Thus, the main focus of the program is to help the state stabilize its finances, which in turn will help it augment and sustain development financing.

16. The program will help the state to launch the necessary reforms for a balanced and sustainable fiscal trajectory over the medium-term, and to meet its development financing needs (capital investment). It will contribute to repositioning and strengthening the budget as the main tool for prioritizing the development objectives. Capital outlay as a percentage of GSDP is expected to rise from less than 1% in FY2012 to 2.4% by FY2016 under the program. The reforms under the program will generate fiscal savings equivalent of $766 million over 5 years (FY2014–FY2018), and $180 million during FY2014–FY2016, and thereby contribute to the twin goals of sustainability of state finances and sustainable increase in development spending. However, a development financing gap (additional capital outlay in the reform scenario net of new fiscal space created under the program) of approximately $252 million during FY2014–FY2016 will remain. ADB funds will help cover this gap.[19]

17. Based on (i) the request of the Government of India and (ii) the development financing requirements of the policy reform program, ADB will provide a policy-based loan of $200 million from ADB's ordinary capital resources. The loan will have a 15-year term, including a grace period of 3 years, an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.15% per year, and such other terms and conditions as set forth in the draft loan agreement. A three-tranche policy framework, consistent with the timings of various reforms, is envisaged. The distribution of the tranches will be $50 million, $50 million, and $100 million, with the first tranche to be disbursed upon loan effectiveness. The second tranche will be disbursed approximately 18 months after loan effectiveness, and the third tranche will be disbursed approximately 7 months after the second tranche disbursement. The government will relend the local currency generated from the proceeds of the total loan amount in accordance with its arrangements for the transfer of external assistance to GOP.

E. Implementation Arrangements

18. The Finance Department of GOP will be the executing agency; the department's secretary will be the focal point for matters pertaining to the program. An FPMU will be

[19] A detailed simulation exercise of the state budget is presented in the Economic Analysis (accessible from the list of linked documents in Appendix 2) under alternative scenarios. Fiscal deficit as a percentage of GDP is expected to decline post FY2014 in the baseline scenario. The rate of decline in the fiscal deficit can be further enhanced if the capital investment (capital outlay) is restricted to the baseline level of 2% (Table 2). However, this will delay much necessary growth and development financing in Punjab.

established with representatives from relevant government departments.

19. The FPMU, which will help line departments implement the program, will be headed by a senior government official. The FPMU will be responsible for (i) coordinating and monitoring the program, including the policy actions; (ii) preparing and submitting all required reports to the higher authorities in GOP and ADB; (iii) submitting quarterly progress reports to ADB; and (iv) helping implement the attached TA.

20. The proposed program will be implemented over a period of 30 months. Procurement, advance contracting, and retroactive financing are not expected. The loan proceeds will be disbursed in accordance with ADB's *Loan Disbursement Handbook* (2012, as amended from time to time) and detailed arrangements agreed upon between the government and ADB. ADB will monitor program implementation through periodic progress reports and will field regular missions to confirm the fulfillment of policy actions for tranche releases.

III. TECHNICAL ASSISTANCE

21. The TA will strengthen the key institutions responsible for implementing the reforms to improve fiscal management performance in the state. The TA has seven components:

(i) **Power subsidy targeting.** Help implement the subsidy rationalization plan, including (a) carrying out technical analysis and surveys to determine normative power consumption for agriculture, and (b) conducting a public awareness campaign.

(ii) **Revenue administration.** Implement the profession tax, an information technology application for improving taxpayer services, and revenue forecasting techniques.

(iii) **Project appraisal and monitoring.** Help establish an FPMU in the Finance Department to provide rigorous medium-term fiscal programming and appraisal and evaluation of the state government projects, support the FPMU in designing manuals based on certain principles, and strengthen the state's internal audit system.

(iv) **Medium-term expenditure frameworks.** Provide support to line departments, as well as to relevant Finance Department officials, to prepare gender-disaggregated expenditure incidence analyses and, drawing on these analyses, prepare relevant MTEFs based on the long-term sector strategies. This support for implementation will include expert advice and training, and assistance with designing detailed guidelines in various areas.

(v) **Employee database.** Help the executing agency prepare a comprehensive and sex-disaggregated database for employees and pensioners of the state government.

(vi) **Debt management.** In line with the weaknesses identified in debt management in the state, build capacity for debt management, including developing appropriate cash management strategies.

(vii) **Internal audit.** Provide support to strengthen internal audit in the state.

22. The TA is estimated to cost $510,000 equivalent, of which $400,000 will be financed on a grant basis by ADB's Technical Assistance Special Fund (TASF-other sources). GOP will provide counterpart support in the form of counterpart staff remuneration, office accommodation and supplies, and other logistical support.

23. The TA implementation arrangements will be aligned with those for the policy-based

loan. The FPMU will implement the TA components; the program steering committee will provide overall supervision and coordination. A total of 38 person-months of national consultancy services will be required intermittently. A consulting firm will be engaged to recruit the consultants using the quality- and cost-based selection method with a standard quality–cost ratio of 90:10. All consultants will be recruited in line with ADB's *Guidelines on the Use of Consultants* (2013, as amended from time to time). All disbursements under the TA will be made in accordance with ADB's *Technical Assistance Disbursement Handbook* (2010, as amended from time to time).

IV. DUE DILIGENCE

A. Technical

24. Information and communication technology-driven initiatives are proposed to improve tax compliance. Introduction of project appraisal techniques and preparation of the MTEFs will require sound technical knowledge. The conduct of the surveys to determine power usage norms for various crops will require sound technical knowledge about crop production, irrigation techniques, and surveys. Capacity building support under the program will help the relevant departments to better manage these technical operations.

B. Economic

25. The economic analysis indicates that program benefits considerably outweigh the costs. The key direct benefits considered are (i) better targeting of subsidies, (ii) better allocation of scarce public resources, (iii) improved public financial management, (iv) improved revenue efforts, and (v) reduced debt service burden due to better management of debt and fiscal consolidation. A comparison of the baseline and the pro-growth reform program scenarios driven by higher capital outlay shows that the overall fiscal deficit is expected to be reduced after 5 years despite higher capital outlay (Table 2).[20]

Table 2: Baseline and Reform Scenarios
(% of gross state domestic product)

Item	FY2014	FY2015	FY2016	FY2017	FY2018
Baseline Scenario					
Fiscal deficit	3.1	3.0	2.8	2.7	2.5
Capital outlay	2.0	2.0	2.0	2.0	2.0
Debt stock	31.7	31.2	30.7	30.1	29.3
Reform Scenario					
Fiscal deficit	3.0	3.1	3.2	2.9	2.7
Capital outlay	2.0	2.2	2.4	2.5	2.5
Fiscal deficit without additional capital outlay	3.0	2.9	2.8	2.4	2.2
Debt stock	31.6	31.3	31.1	30.6	30.0

FY = fiscal year.
Source: Asian Development Bank estimates.

26. Fiscal space created under the program, resulting from expenditure rationalization and improved revenue efforts, will contribute to this outcome. Moreover, the debt stock–GSDP ratio

[20] These projections will be revisited while preparing the MTFF (Policy Action No. 17 under the third tranche) following the (i) Fourteenth Finance Commission Awards and (ii) the expected rollout of the goods and services tax.

will decline.[21] The other important economic benefit of the program is the promotion of a development model that facilitates conservation of natural resources, such as water, by targeting the power subsidy for agriculture in an efficient manner.

C. Governance

27. As part of program preparation, a governance risk assessment was conducted in accordance with the implementation guidelines of ADB's Second Governance and Anticorruption Action Plan. The assessment was complemented by a review of areas of possible risk and vulnerability in state financial management. The assessment found some vulnerable areas that could affect the program. They include risks related to (i) political support and ownership of policy reforms by the state government and (ii) institutional dimensions of the program (e.g., weak capacity in relevant institutions). The financial assessment found several areas of concern: (i) lack of appraisal and evaluation of investment projects, (ii) weak implementation and moderate monitoring protocols, (iii) inadequate internal audits, and (iv) no alignment between sector goals and resource allocation.[22] Accordingly, a detailed results-based public sector management assessment was carried out, and these risks, especially in the areas of evaluation and implementation, are being addressed through the policy actions and/or through the capacity development under the TA.

D. Poverty and Social

28. The poverty reduction and social impacts of the program are positive. The program's special emphasis on enhancing investment in economic and social infrastructure is clearly geared to creating employment opportunities and protecting the poor and other vulnerable groups. Moreover, the program will continue to support free power for families living below the poverty line. The health indicators for women and children in the state are weaker than in other developed states due to ineffective delivery of public services, especially in rural areas (causing large rural–urban divides) and lack of adequate budget allocations. This is manifested in many ways. For example, high incidence of cancer, sharp rural–urban disparities in maternity care, institutional births, postnatal care, and child immunization in Punjab reflect inadequate health services. Rectifying these problems becomes all the more challenging if the state government is unable to invest in a targeted manner.[23] As a result, the program will be designed with some gender elements to ensure that women receive benefits. The gender-responsive MTEFs, based on long-term sector goals, are expected to improve targeting of public expenditure, especially gender-related allocation of scarce public resources. This will be ensured through MTEF policy actions and gender responsive expenditure incidence analysis. The MTEFs will be revised annually.

E. Safeguards

29. The three safeguard categories—environment, involuntary resettlement, and indigenous peoples—are categorized as C.

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[21] Details are provided in the Economic Analysis (accessible from the list of linked documents in Appendix 2).
[22] Results-Based Public Sector Management Assessment Framework (accessible from the list of linked documents in Appendix 2).
[23] Summary Poverty Reduction and Social Strategy (accessible from the list of linked documents in Appendix 2).

F. Risks and Mitigating Measures

30. Major risks and mitigating measures are summarized in Table 3 and described in detail in the risk assessment and risk management plan.[24] The integrated benefits and impacts are expected to outweigh the costs.

Table 3: Summary of Risks and Mitigating Measures

Risks	Mitigating Measures
Lack of continued government commitment to the reforms, and to allocating resources for their implementation	Continued engagement with GOP to send a consistent message about the need for reforms. Showcasing of best practices and an awareness campaign highlighting the long-term benefits will remain crucial. Develop MTEFs for the major spending departments with the TA support.
Weak implementation capacity of line departments	Support will be provided under the attached TA to help the FPMU.
Weak capacity for internal audit	Support will be provided under the attached TA.
Difficulty adhering to expenditure-rationalizing measures, such as provisions in the MTEFs, and improved targeting of subsidies due to state elections	Consistent and sustained engagement with GOP and showcasing of best practices from India are needed. Maintain dialogue and collaboration with the Department of Expenditure of the Government of India on initiating and sustaining fiscal reforms in the state.
Lack of participation by the farmers in implementing targeting of power subsidies	Effective and sustained public awareness campaign is necessary to mitigate this risk.

FPMU = fiscal policy and management unit, GOP = Government of Punjab, MTEF = medium-term expenditure framework, TA = technical assistance.
Source: Asian Development Bank.

V. ASSURANCES

31. The government and GOP have assured ADB that implementation of the program shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement.

VI. RECOMMENDATION

32. I am satisfied that the proposed policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of $200,000,000 to India for the Punjab Development Finance Program, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; for a term of 15 years, including a grace period of 3 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan and program agreements presented to the Board.

Takehiko Nakao
President

28 October 2014

[24] Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
Impact Improved capital investment in the state	By FY2018 Capital outlay to GSDP ratio is not less than 2.5% (Baseline: actual capital outlay to GSDP ratio of 0.7% in FY2012). The share of capital outlay in education and health is at least 20% of total capital outlay (Baseline: 15.5% in FY2012).	Finance accounts and budget documents of GOP Reserve Bank of India reports on state finances Special coordinated joint monitoring by the Government of India and ADB	**Assumption** GOP remains committed to fiscal reforms. **Risk** Political forces could resist reform measures.
Outcome Larger and more sustainable fiscal space in the state government	By FY2016 Own-tax revenue is at least 9% of GSDP (Baseline: 7.9% in FY2012). Revenue deficit contained at around 0.7% of GSDP (Baseline: actual revenue deficit to GSDP ratio was 2.6% in FY2012).	Finance accounts and budget documents of GOP Finance accounts and budget documents of GOP	**Assumption** No additional and ad hoc transfer payments and/or subsidies
Outputs 1. Improved capacity for fiscal management	By FY2016 Major public investment approvals of GOP are vetted by the FPMU (Baseline: FPMU does not exist). Well-documented gender responsive MTEFs in place for major spending departments (Baseline: no MTEF in place) The cash management system is developed and operational (Baseline: system is currently not in place). Not more than 3%–4% discrepancies between estimated (budgeted) and actual own-tax revenue and total expenditure (excluding debt servicing payments) (Baseline: 5% for own-tax revenue and 12.8% for total expenditure in FY2012)	Notifications and reports from the Finance Department Budget documents of GOP Notifications and reports from the Finance Department Finance accounts and budget documents of GOP	**Assumptions** GOP's commitment to the FPMU cell continues. No unplanned spikes are found in current expenditure. Internal audit system is strengthened. **Risk** State elections result in difficulty adhering to the provisions in the MTEFs.

Design Summary	Performance Targets and Indicators with Baselines	Data Sources and Reporting Mechanisms	Assumptions and Risks
2. Rationalized expenditure focusing on power subsidies	By FY2016 Agricultural power supply data disaggregated at feeder levels and documented (Baseline: not available). Power subsidy per hectare of gross cropped area declines by at least 4% over no reform scenario (No reform scenario: Rs11,920 in FY2016).	Annual report of PSPCL Annual report of PSPCL	**Assumptions** Punjab government remains committed to subsidy rationalization reform. Effective public communication strategy is implemented.
3. Improved revenue efforts	By FY2016 Digitization of land records is completed in the state (Baseline: 75% of rural areas is completed). Profession tax bill is introduced in the state assembly (Baseline: none).	Notification from the Revenue Department Statement from the Finance Department of GOP	**Assumption** Finance Department, GOP allocates adequate financial and human resources for capacity building.

Activities with Milestones	Inputs
1. Improved capacity for fiscal management 1.1 Establish an FPMU (by Q3 2013) 1.2 Prepare a long-term sector strategy and road map for major spending departments (by Q3 2015) 1.3 Institute a system of project appraisal reports for all new projects and project performance evaluations for existing projects and link them with fund allocations (by Q2 2015) 1.4 Prepare rolling MTEFs for the departments of health, education, power, and public works (by Q1 2016) 1.5 Prepare the budget (for the relevant year) based on the new MTEFs (by Q1 2016) 1.6 Prepare electronic database for government employees and pensioners (by Q2 2016) 1.7 Prepare a manual for cash forecasting and management (by Q2 2016) **2. Rationalized expenditure focusing on power subsidies** 2.1 Prepare the strategy paper with alternative plans for improved targeting of agricultural power subsidies (by Q3 2013) 2.2 Agricultural power supply data substantially disaggregated at the feeder level (by Q3 2013)	**Policy-Based Loan:** ADB: $200 million **TA Grant:** ADB: $0.4 million

Activities with Milestones	
2.3 Complete the surveys to determine crop-specific and/or region-specific normative power consumption (by Q4 2015) 2.4 Complete the public awareness campaign (by Q1 2016) 2.5 PSPCL to complete metering distribution transformers connected to agriculture (by Q4 2015) 2.6 Complete the manual for projecting monthly power demand (by Q4 2015) 2.7 Prepare the debt restructuring plan for PSPCL (by Q4 2015) **3. Improved revenue efforts** 3.1 Develop the road map for strengthening VAT administration and taxpayer services (by Q2 2015) 3.2 Develop the road map for introducing profession tax (by Q3 2015)	

ADB = Asian Development Bank, FPMU= fiscal policy and management unit, FY = fiscal year, GOP = Government of Punjab, GSDP = gross state domestic product, MTEF = medium-term expenditure framework, PSPCL = Punjab State Power Corporation Limited, Q = quarter, TA = technical assistance, VAT = value-added tax.
Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

http://www.adb.org/Documents/RRPs/?id=45288-002-3

1. Loan Agreement
2. Program Agreement
3. Sector Assessment (Summary): Public Sector Management
4. Contribution to the ADB Results Framework
5. Development Coordination
6. Attached Technical Assistance
7. Country Economic Indicators
8. International Monetary Fund Assessment Letter
9. Summary Poverty Reduction and Social Strategy
10. Risk Assessment and Risk Management Plan
11. List of Ineligible Items

Supplementary Documents

12. Economic Analysis
13. Results-Based Public Sector Management Assessment Framework
14. Strategy Paper for Improved Targeting of Agriculture Power Subsidy
15. Indicative Terms of Reference for Consultants

DEVELOPMENT POLICY LETTER

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सत्यमेव जयते

Appendix 3
भारत सरकार
वित्त मंत्रालय
आर्थिक कार्य विभाग
नॉर्थ ब्लाक, नई दिल्ली-110001

Government of India
Ministry of Finance
Department of Economic Affairs
North Block, New Delhi-110001

D.O.No.5/6/2014-ADB-I

1st September, 2014

Dear Nakao San,

I am writing this in the context of the Punjab Development Finance Program loan.

2. I am attaching a copy of the letter dated 28.08.2014 of the Government of Punjab to the Government of India, expressing their unequivocal commitment to implement the Punjab Development Finance Program. Negotiations for a loan of US$ 200 million for this purpose will be held on 3-4 September, 2014.

3. I am pleased to convey the full support of the Government of India to the Government of Punjab in implementing the program and request ADB to lend US$ 200 million from its Ordinary Capital Resources so as to enable Government of India to on-lend these funds to the Government of Punjab.

4. I assure you of the highest consideration of the Government of India.

With regards,

Yours sincerely,

(DINESH SHARMA)

Mr. Takehiko Nakao,
President,
Asian Development Bank,
6 ADB Avenue, Mandaluyong City,
1550 Metro Manila,
Philippines.

Sarvesh Kaushal
ਸਰਵੇਸ਼ ਕੌਸ਼ਲ

D.O. No. 12/12/2012/-3FB.II/ 1581

Chief Secretary to Govt. of Punjab
Chandigarh - 160 001

ਮੁੱਖ ਸਕੱਤਰ, ਪੰਜਾਬ ਸਰਕਾਰ
ਚੰਡੀਗੜ੍ਹ - 160 001

Phone/ਫੋਨ : 0172-2740156, 2740860
Fax/ਫੈਕਸ : 2742488
Email : cs@punjabmail.gov.in

Dated, Chandigarh: 18-08-14

Subject: Development Policy letter.

Dear Shri A. Mayaram,

Kindly refer to D.O. letter No.12/12/2012-3FBII/683 dated 24th July, 2013 of my predecessor on the subject cited above. The Government of Punjab is fully committed to improve its finances in line with a sound and comprehensive fiscal consolidation plan. This is essential to augment and sustain development financing in the state. We recognize that improved financial management is an important pre-requisite for meeting state's developmental agenda, including higher growth and adequate employment generation.

2. In the medium term, and to contribute towards the attainment of the desired outcomes, our strategy is primarily centered on (i) improving capacity for fiscal management, (ii) rationalizing expenditure, with a focus on power subsidies, to allocate scarce public resources productively, and (iii)strengthening state's revenue mobilization efforts. With these initiatives, I am confident that the Government of Punjab can augment and sustain development financing. A second subprogram will ensure deepening and sustainability of reforms.

Development Finance Reform Program

3. The proposed Program that we seek to put in place, with the assistance of the Asian Development Bank (ADB), will help us address the

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strategic areas focus as stated above. More specifically, ADB's support will be utilized to initiate key reforms in the following areas:

(i) Institute a proper system of long-term expenditure planning for improved allocative and technical efficiency of total expenditure through the introduction of (a) project appraisal, monitoring, and evaluation; (b) medium-term expenditure frameworks in some selected departments; and (c) better cash management and enhanced debt management capacity so that there is better debt recording, debt servicing, accounting for debt transactions, and overall debt management, including government on lending and guarantees;

(ii) Initiate a system of better targeting of power subsidies through both demand and supply side measures. The demand side measures will primarily incentivize the farmers to economize the use of power. The normative power requirements will be worked out based on certain key parameters for this purpose. The supply side measures will help the Punjab State Power Corporation Limited (PSPCL) to improve efficiency of power supply. These include among others feeder segregation, feeder and distribution metering, appropriate short-term power requirements forecasts, and more importantly a time-bound debt restructuring action plan for PSPCL; and

(iii) Improve the state's tax efforts by strengthening tax administration in commercial taxes and introducing profession tax in the state.

4. The outcomes of the proposed Program will be reflected in, and monitored through, among others (i) continued moderation in the key deficit targets; and (ii) sustained improvements in the capital outlays to gross state domestic product (GSDP) ratio. A medium-term fiscal framework (MTFF) covering the period of t+3 years will be prepared and integrated with the budget to ensure adherence to realistic fiscal targets and with clear enhancement of capital outlays (as a percentage of GSDP).

5. We believe that the proposed Program, as presented, is the right approach to fiscal and economic reforms in Punjab and could be implemented

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over two years. We recognize the challenges and risks entailed in this proposed Program but remain committed to its implementation. We also confirm that the policy actions proposed under this program are reflective of and fully in consonance with the reform agenda of the Government.

6. We would like to thank ADB for working closely with the Government in developing this Program and would like to reiterate our full support for it.

7. This issues with the approval of Hon'ble Chief Minister, Punjab.

With best regards

Yours sincerely,

(Sarvesh Kaushal)

Shri A. Mayaram, IAS,
Secretary to Govt. of India,
Ministry of Finance,
Department of Economic Affairs,
North Block, New Delhi.

POLICY MATRIX

Objective: To support the Government of Punjab to reorient its public finance for augmenting and sustaining development financing.

First Tranche	Second Tranche (Approximately 18 months after the first tranche or earlier)	Third Tranche (Approximately 7 months after the second tranche or earlier)
I. Improved Capacity for Fiscal Management Objective: To improve allocative efficiency and effectiveness of public resources.		
1. FRBM rules drafted and approved by Finance Department for effective implementation of the provisions and targets under FRBM Act. **(Document required: Copy of the draft FRBM Rules approved by Finance Department)**		16. FRBM rules adopted by GOP**. (Document required: GOP notification of the FRBM rules)**
2. FPMU in the Finance Department set up by GOP and made fully operational to supervise (i) project appraisal and evaluation, (ii) debt and cash management, and (iii) overall program implementation to strengthen fiscal management and improve effectiveness of public resources. **(Document required: Copy of Finance Department notification)**		17. MTFF for FY2016–FY2018, which provides a reasonable enhancement of capital outlay (as a percentage of GSDP) over the baseline scenarios, prepared and approved by Finance Department to ensure adherence to realistic fiscal targets. **(Document required: Copy of the MTFF approved by Finance Department)**
3. A roadmap for the introduction of the gender-responsive MTEF is approved by Finance Department to improve allocative efficiency of scarce public resources. **(Document required: MTEF roadmap as approved by Finance Department)**		18. Gender-responsive MTEFs for health, education, power, and public works departments, which are consistent with MTFF, finalized and approved by Finance Department, and budget allocations for these departments made for FY2016 based on MTEFs **(Document required: MTEF reports and budget allocations statement as approved by Finance Department)**
		19. Comprehensive electronic database on GOP employees and pensioners

First Tranche	Second Tranche (Approximately 18 months after the first tranche or earlier)	Third Tranche (Approximately 7 months after the second tranche or earlier)
		prepared by Finance Department for better public expenditure planning and targeting. **(Document: Report on database prepared by Finance Department)**
		20. Finance Department to implement a treasury cash forecasting methodology and its integration with debt management module, to reduce dependence on unplanned short-term borrowings**. (Documents required: Treasury cash forecasting concept note and a status report on implementation as approved by Finance Department)**
II. Rationalized Expenditure focusing on Power Subsidies Objective: To support a compositional shift in public spending and generate additional 'fiscal space' for developmental spending.		
4. PSPCL to submit agriculture power feeder data, covering at least 90%–95% of total agriculture power consumption, to PSERC for tariff determination of FY2013.**(Document required: PSERC electricity tariff order for FY 2013)**		
5. PSPCL to complete 100% feeder metering. **(Document required: Report submitted by Power Department)**	9. PSPCL to complete 100% metering on distribution transformers connected to agriculture power feeders to improve energy audit**. (Document required: Report submitted by Power Department)**	
6. GOP to approve a strategy paper with alternative plans for improved targeting of agricultural power subsidies. **(Document required: Strategy paper approved by Finance Department)**	10. GOP to notify an agricultural power subsidy targeting plan selected from the alternative plans provided in the strategy paper and to commence implementing the selected plan.	

First Tranche	Second Tranche (Approximately 18 months after the first tranche or earlier)	Third Tranche (Approximately 7 months after the second tranche or earlier)
	(Document required: Copy of the notification and an action taken report issued by Power Department)	
7. GOP to finalize a public awareness campaign plan to facilitate implementation of the agricultural power subsidy targeting plan**. (Document required: Copy of the finalized public awareness campaign plan)**	11. GOP to implement the public awareness campaign to facilitate implementation of the selected agricultural power subsidy targeting plan. **(Document required: Report prepared by Finance Department on the public awareness campaign)**	
	12. PSPCL to (i) implement a system of demand forecasting and energy requirement to manage short- and long-term power purchase costs in an effective manner, and (ii) include the same in its petition to PSERC. **(Document required : Petition submitted by PSPCL to PSERC on demand forecasting and energy requirement)**	
	13. Power Department to approve a time-bound action plan for PSPCL debt restructuring to facilitate funds mobilization from the market and improve power supply and to commence implementing the plan. **(Document required: A copy of the debt restructuring action plan and an action taken report issued by Power Department)**	
III. Improved Revenue Efforts Objective: To improve own-revenue mobilization by strengthening revenue administration and introducing new sources of revenue.		
		21. Finance Department to reduce threshold limit for deduction of tax at source for works contract.

First Tranche	Second Tranche (Approximately 18 months after the first tranche or earlier)	Third Tranche (Approximately 7 months after the second tranche or earlier)
		(Document required: Copy of the Finance Department notification)
		22. Finance Department to benchmark the turnover tax rate in the comparable states and revise the turnover tax rate appropriately. **(Document required: Copy of the Finance Department notification)**
	14. GOP to submit the profession tax bill to the State legislature. **(Document required: Copy of the profession tax bill submitted to the State legislature)**	
8. Revenue Department to complete 75% digitization of land records in all rural areas of the state to facilitate improved administration of stamp duty and registration fee collection from the rural areas. **(Document required: Report on completion issued by Revenue Department)**	15. Revenue Department to complete the digitization of land records for all areas of the state. **(Document required: Report on completion issued by Revenue Department)**	

FPMU = fiscal policy and management unit, FRBM= Fiscal Responsibility and Budget Management, GOP= Government of Punjab, GSDP= gross state domestic product, MTEF= medium-term expenditure framework, MTFF= medium-term fiscal framework, PSPCL = Punjab State Power Corporation Limited, PSERC= Punjab State Electricity Regulatory Commission.

Source: Asian Development Bank and Government of Punjab.