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TECHNICAL ASSISTANCE REPORT—STATE OF TAMIL NADU—MODERNIZING BUDGET FORMULATION AND MANAGING FISCAL RISKS

This technical assistance report on India, State of Tamil Nadu was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in December 2019.

Disclaimer:
This document was prepared before COVID-19 became a global pandemic and resulted in unprecedented economic strains. It, therefore, does not reflect the implications of these developments and related policy priorities. We direct you to the **IMF Covid-19 page** that includes staff recommendations with regard to the COVID-19 global outbreak.

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India–State of Tamil Nadu

Modernizing Budget Formulation and Managing Fiscal Risks

Lesley Fisher, Murray Petrie, Gemma Preston, and Claude Wendling

Technical Report

February 2020

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PREFACE

At the request of the Tamil Nadu State authorities, a team from the IMF's Fiscal Affairs Department (FAD) and the IMF's South Asia Regional Training and Technical Assistance Center (SARTTAC) visited Chennai, Tamil Nadu, from December 3–December 17, 2019, to review and provide advice on Tamil Nadu State's public financial management (PFM) reforms, notably with respect to budget formulation and fiscal risks.

The mission team was led by Lesley Fisher (SARTTAC) and comprised Murray Petrie, Gemma Preston, and Claude Wendling (all IMF FAD Experts). Andrew Ceber (SARTTAC) joined the mission on December 16–17. Mr. Sukhwinder Singh, Director of SARTTAC, attended mission meetings on December 9–10.

The team was briefed by Mr. S. Krishnan, Indian Administrative Service (IAS), Additional Chief Secretary to Government (ACS), Finance Department, at the beginning of the mission. It also met with other senior officers of the Finance Department, including: M. A. Siddique, IAS, Principal Secretary to Government (Expenditure); Dr. R. Anandakumar, IAS, Special Secretary to Government; P. Kulkarni, IAS ; Special Secretary to Government; H. Krishnanunni, IAS, Deputy Secretary to Government, (Budget); M. Arvind, IAS, DS; S. Arunraj, IAS, DS; S. Girirajkumar, DS (Finance Commission); M. Raja, DS (Infrastructure Cell); C.R. Balaji, Joint Director, and T.V. Permgopal (both Bureau of Public Enterprises).

The mission also met with officials of other agencies involved in budget formulation and fiscal risks, including: Dr. T. V. Somanathan, IAS, ACS, Commissioner of Commercial Taxes; K. Ravichandran, Joint Director, Commissionerate of Transport; K. Gnanasekaran, Joint Director, Commissionerate of Commercial Taxes; B. Arun Satya, Joint Commissioner, Prohibition and Excise Department; B. Geetha, DS, Planning and Development Department; S. Senthu Baskar, Joint Director, Evaluation and Applied Research Department; Dr. K. Radhakrishnan, Director, Special Programme Implementation Department; Dr. P. Balasubramanian, Additional Director, and D. S. Barathi, Additional Director, both Department of Economics and Statistics; D. Sridhar, Director, Co-operative Audit Department; P. Velusamy, Director, Local Fund Audit Department; R. Muthukumar, Director, State Government Audit Department; K. Selvakumar, Joint Secretary to Government, Commissionerate of Municipal Administration; D. Mahesh Babu, Joint Director, Directorate of Rural Development, and Panchayat Raj; P. G. Babu, Director, Madras Institute of Development Studies.

The mission also met with senior officials from several line ministries: Dr. K. Manivasan, IAS, Principal Secretary to Government for the Highways & Minor Ports Department; Dr. P. Umanath, IAS, Managing Director of the Tamil Nadu Medical Services Corporation Limited; Dr. Swathi, Director of Medical Services, and Dr. Narayana Babu, Director of Medical Education for the Health and Family Welfare Department; N. Muruganandam, IAS, Principal Secretary to the Government for the Industries Department; and Dheeraj Kumar, IAS, Principal Secretary to Government for the Energy Department.

The mission held meetings with senior representatives from several Public Sector Undertakings: Vikram Kapur, IAS, ACS, Chairman and Managing Director of Tamil Nadu Electricity Board and of Tamil Nadu Generation and Distribution Corporation (TANGEDCO), as well as other representatives from TANGEDCO and Tamil Nadu Transmission Corporation; J. Kumaragubaran, IAS, Managing Director, State Industries Promotion Corporation of Tamil Nadu; P. Annamalai, IAS, Director, Poompuhar Shipping Corporation; M. Gnanasekaran, General Manager, Tamil Nadu Road Development Company; and K. Sekar, Superintending Engineer, Chennai Kanyakumari Industrial Corridor Project.

A meeting was held with Mr. Jaisankar (IA&AS), the Accountant General of Tamil Nadu, and his team.

The mission attended a presentation of the new Integrated Financial and Human Resource Management System (IFHRMS) by M. Srinivasa Ragavan, Programme Head for Wipro.

Mr. Krishnan, ACS, received the mission team at the end of its stay for a wrap-up meeting and handover of a draft technical assistance report.

The mission team would like to thank officials from the State government for their warm hospitality and cooperation and for their constructive discussions on all topics raised during the mission. The mission would like to express special thanks to H. Krishnanunni and his team, in particular, Mr. R. Narasimha Ragavan, for their excellent support in organizing the mission, setting up meetings, and providing documentation.

ABBREVIATIONS

ACS	Additional Chief Secretary to the Government
AE	Advanced Estimates
BE	Budget Estimates
BPE	Bureau of Public Enterprises
CABRI	Collaborative Africa Budget Reform Initiative
CAG	Comptroller and Auditor General of India
CSF	Consolidated Sinking Fund
DCBs	Decentralized Budget Meetings
DPE	Department of Public Enterprises
DS	Deputy Secretary to Government
FAD	Fiscal Affairs Department
FRBM Act	Fiscal Responsibility and Budget Management Act
FD	Finance Department
FY	Fiscal Year
GDP	Gross Domestic Product
GOI	Government of India
GRF	Guarantee Redemption Fund
GSDP	Gross State Domestic Product
GST	Goods and Services Tax
IAS	Indian Administrative Service
IBEF	India Brand Equity Foundation
IFHRMS	Integrated Financial and Human Resource Management System
IMF	International Monetary Fund
INR	Indian Rupees
IT	Information Technology
MTBF	Medium-Term Budget Framework
MTFF	Medium-Term Fiscal Framework
MTFP	Medium-Term Fiscal Plan
PCB	Program cum Budget
PFM	Public Financial Management
PPPs	Public Private Partnerships
PSUs	Public Sector Undertakings
RE	Revised Estimates
SARTTAC	South Asia Regional Training and Technical Assistance Center
SOE	State-Owned Enterprise
SOTR	State Own Tax Revenue
TANGEDCO	Tamil Nadu Generation and Distribution Corporation
TNERC	Tamil Nadu Electricity Regulatory Commission
TNFRA	Tamil Nadu Fiscal Responsibility Act, 2003
TNIDB	Tamil Nadu Infrastructure Development Board
TNMSC	Tamil Nadu Medical Services Corporation
UDAY	Ujwal DISCOM Assurance Yojana

EXECUTIVE SUMMARY

Although Tamil Nadu's public financial management has been characterized by strong fiscal discipline to date, risks and challenges are emerging. The State has largely observed the Fiscal Responsibility Act targets on debts and deficit (25 percent and 3 percent to GSDP, respectively) except during the electricity bailout in 2016–17.[1] However, these targets appear to have been met by (1) controlling and delaying expenditure, (2) underallocating mandated payments to various reserve funds, and (3) allowing off-budget borrowing by Public Sector Undertakings (PSUs). Accordingly, the State's borrowing capacity is restricted, leaving limited fiscal space to address high priority needs in education, health, electricity, roads, and water sectors, as well as to address growing infrastructure pressures. More than 63 percent of the State's spending on current items is committed, to salaries, pensions, and interest payments. Little room remains for additional borrowing to fund spending pressures; moreover, climate change is likely to exacerbate fiscal risks from water stress and natural disasters.

These risks and challenges present an excellent opportunity for the State to modernize its financial management. Doing this could be accomplished by, among other things, strengthening the macrofiscal function, including changing the composition of spending and allocating resources more efficiently to policies that contribute to the growth and development of Tamil Nadu.

The State's budget formulation practices are incremental, have weak links to resource availability, and are largely focused on the traditional approach of approving and controlling spending. The budget calendar is compressed into six months, leaving departments inadequate time to develop credible estimates.[2] Revenue estimates are adjusted to meet unrealistic expenditure estimates and are not informed byan actual assessment of revenue potential**.** The budget is characterized by frequent reallocations, with up to three supplementary budgets in some years. Frequent revisions undermine the credibility of the annual budget and distract budget officials from ensuring that budget estimates are well costed, linked to performance, and realistic—known as the "challenge function."

Tamil Nadu's Finance Department is well-positioned to address these challenges in budget formulation. It is equipped with experienced and skilled staff who could develop capabilities for macrofiscal forecasting, top-down budgeting, exercise of a budget challenge function, and fiscal risk management. Tamil Nadu's planned implementation of an Integrated Financial and Human Resource Management System (IFHRMS) could accelerate the modernization process by streamlining information exchanges during budget formulation, facilitating multiyear expenditure forecasting, and introducing an examination of performance outcomes with the budget.

Fiscal risk management requires urgent attention to avoid a recurring crisis in the electricity industry and to avoid problems in the passenger transport sector. The imbalance between electricity revenue and tariff costs has left funding gaps with the State-run Tamil Nadu Generation

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[1] The Ujwal Discom Assurance Yojana (UDAY) Scheme implemented in 2015–16 required States to take over 75 percent of the debt of their electricity generation companies over two years and to turn around their finances.

[2] In accordance with good international practice, line departments should be given at least two months to develop their detailed budget proposals within approved budget ceilings.

and Distribution Corporation Limited (TANGEDCO). Although the PSU has not yet defaulted on its debt obligations, its fiscal stress is manifested in ongoing annual losses; increasing negative net worth; and arrears to solar, thermal, and wind producers. The State could consider bringing in professional advisors to assist with the reform of electricity and passenger transport sectors and to quantify the quasi-fiscal activities performed by the related PSUs, for example, free electricity to farmers. Untargeted electricity and passenger subsidies add to the fiscal stress of PSUs. The Tamil Nadu Infrastructure Development Board (TNIDB) would require further capacity within the government to effectively manage public-private partnerships (PPPs), including monitoring the fiscal risks from a pipeline of 169 new planned PPPs; the PSUs currently rely on consultants to evaluate the PPP proposals. The Finance Department should review the legal framework for PPPs to ensure that it has an adequate formal budget gatekeeper role with respect to each proposed PPP project.

Large PSUs in the electricity and transport sectors are on an unsustainable path and require financial management reform. These PSUs currently prepare only annual budgets; they do not provide in-year reports to their oversight departments on fiscal pressures, including those from accumulated expenditure arrears, court cases, or debt payments. Ex-ante monitoring of PPPs, PSUs, local government debt, and major legal claims could help the State to manage fiscal risks and to introduce steps to mitigate these risks. Similarly, the fiscal impacts of natural disasters, pensions, and off-budget borrowing require closer scrutiny and regular reporting.

Comprehensive fiscal risk reporting and disclosure is in its infancy in Tamil Nadu, and the government has yet to build a complete picture of the risks that could adversely affect the State's finances. In some areas, such as guarantees, loans, and PSUs, the government provides detailed disclosure on its activities. In other areas, such as macroeconomic risks, legal claims, and pension liabilities, such disclosure is limited, even where some internal reporting occurs. By reporting on the fiscal risks to which the State is exposed, officials can better understand the source of risks, the likelihood of risks materializing, and their potential impact on the fiscal position**.** Fiscal risk reporting would help to target risk management plans by identifying actions to mitigate the risks. With the State starting to reach its debt limits, future surprises that include bailouts of PSUs and local governments—an implicit responsibility of the State—will be difficult to accommodate without active and comprehensive management of fiscal risks.

The 2003 Tamil Nadu Fiscal Responsibility Act could be amended to require the disclosure of more information on fiscal risks. Many countries prepare a fiscal risk statement to promote a better understanding of the true state of the public finances, strengthen accountability for risk management, and mitigate these risks. Developing a fiscal risk register could be a useful step toward risk mitigation**.** These measures to improve the disclosure and demonstrate a proactive, forward-looking, and comprehensive approach to fiscal risk management would enhance Tamil Nadu's competitive ability vis-a-vis other States to attract investment.

To implement the reforms recommended in this report (Table 1), the Finance Department needs to further enhance its capacity, including by establishing a macrofiscal unit and a fiscal risk management unit. The department could benefit from IMF technical assistance to evaluate its current functions and identify any reorganization required to move from traditional spending control to more strategic functions, including fiscal oversight and monitoring policies. The State would require the approval of the Department of Economic Affairs to develop a workplan supported by SARTTAC.

Table 1. Summary of Recommendations

Theme	Reform area	Recommendation	Short term	Medium term	Technical Assistance
Capability and Capacity	1. Organization of the Finance Department (FD)	**A.** Request a FAD mission to evaluate and upgrade the capacity and capability of the FD to implement reforms	✓		
Reinforcing budget credibility	2. Strengthening macrofiscal forecasting	**A.** Develop the capacity, supported by SARTTAC, to create a macrofiscal capability within the FD.	✓		✓
		B. Implement a medium-term fiscal framework to anchor the overall budget formulation process.		✓	✓
	Annual and medium-term budgeting	**A.** Extend the budget calendar, to introduce macrofiscal forecasting (April-June) and update regularly.	✓		
		B. Introduce a budget challenge function to improve the credibility of annual budget estimates.		✓	
		C. Seek a political mandate for a transition to a top-down budgeting process.		✓	
		D. Pilot the process with selected departments, for example, industry, and provide them with spending ceilings in exchange for reliable estimates.		✓	✓
		E. Gradually introduce medium-term budgeting, once annual budget estimates improve.		✓	✓
		F. Publish a brief citizens' budget alongside budget 2020–21.	✓		
		G. Develop a fiscal strategy report based on the macrofiscal forecast with budget 2021-22, and gradually improve the quality and content of the report.		✓	✓
Fiscal risk management	Managing exposure to fiscal risk	**A.** Establish an FD requirement that TANGEDCO and the Transport Passenger Group prepare three-year financial forecasts and estimates of costs their noncommercial obligations.	✓		
		B. Implement an FD decision to seek an immediate government decision to instruct TANGEDCO to file for a tariff increase.	✓		
		C. Appoint external professional advisers to analyze the accounts of TANGEDCO and the Transport Passenger Group, identify beneficiaries of subsidized prices, and report options for turning around the companies' finances.	✓		
		D. Include progressively in the budget the full costs of meeting noncommercial obligations in the energy and transport sectors.		✓	✓
		E. Build gradual capacity to provide forward-looking oversight of the energy and transport sector PSUs.	✓		
		F. Request IMF support to develop and implement a medium-term revenue strategy.	✓		✓
		G. Conduct a debt sustainability analysis.	✓		✓
		H. Develop a medium-term debt management strategy within Ways and Means unit		✓	✓
		I. Implement review of legal framework for PPPs to include a formal budget gatekeeper role with respect to each proposed PPP project.	✓		✓
		J. Instruct all line departments to maintain registers of expenditure arrears and legal actions, and report the information to FD.	✓		✓
		K. Introduce system of monitoring finances of local governments.		✓	✓
	Fiscal risk reporting	**A.** Establish a central fiscal risk function within FD	✓		
		B. Develop a comprehensive approach to fiscal risk reporting, including in-year reporting using a fiscal risk register as a starting point.	✓		✓
		C. Publish a Fiscal Risk Statement with the budget documents.		✓	✓
		D. Introduce fiscal risk disclosure requirements into the TNFRA.		✓	✓

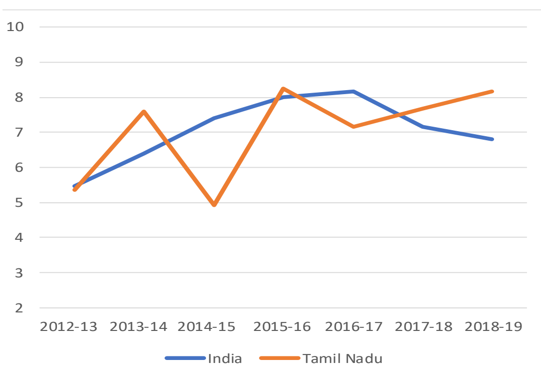
I. REINFORCING BUDGET CREDIBILITY

A. Strengthening Macrofiscal Planning

1. Tamil Nadu's economy and public finances compare favorably to other Indian States. The State contributes around 8.8 percent to the overall GDP of India (2016/2017).[3] The economy is diversified, with a significant industrial base and a per capita GSDP that is more than 80 percent above the Indian average.[4] Economic growth averaged more than 7 percent from 2011 to 2019, similar to an average of 7.1 percent for the whole of India. Gross State government debt remains slightly below 25 percent of GSDP.

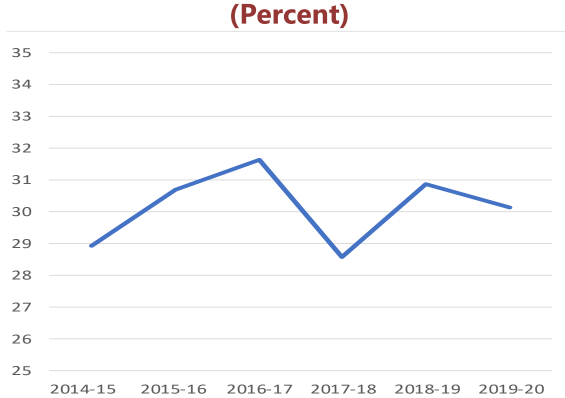
2. Uncertainties exist that could affect fiscal sustainability. Any slowdown in the national economy may adversely affect Tamil Nadu's industrial sector, reducing income and government revenues **(Figure 1)**. The end of the Goods and Services Tax (GST) compensation planned for 2022 could further strain finances. Any reduced share of central government transfers anticipated in the 15th Finance Commission recommendations may exert further pressure on the Tamil Nadu's fiscal position **(Figure 2).**

Figure 1. Gross State Domestic Product Growth in Tamil Nadu (2012–18, Percent)



Sources: IMF Staff estimates based on government data

Figure 2. Transfers from the Union as a Share of Tamil Nadu's Total Resources (Percent)



Source: India Brand Equity Foundation (IBEF), 2016/17 data.

[3] India is composed of 28 States and 8 Union territories.

[4] Per capita GSDP (in USD) is 2,548 in Tamil Nadu, as opposed to 1,399 for India as a whole.

Current Situation

3. The Tamil Nadu Fiscal Responsibility Act (TNFRA 2003, amended in 2017) serves as a fiscal anchor. Fiscal management principles described in Section 4 of the TNFRA provide for a debt-to-GSDP ceiling of 25 percent and a deficit[5] ceiling of 3 percent.[6] These two fiscal rules have been generally adhered to in recent years (**Figure 3 and Figure 4**), with the exception of 2016/2017, when the deficit reached 4.4 percent of GSDP due to the impact of a bailout of the public power company, Tamil Nadu Generation and Distribution Corporation (TANGEDCO), which was authorized by the central government and known as "Ujwal DISCOM Assurance Yojana" (UDAY).

Figure 3. Fiscal Deficit (Percent of GSDP)

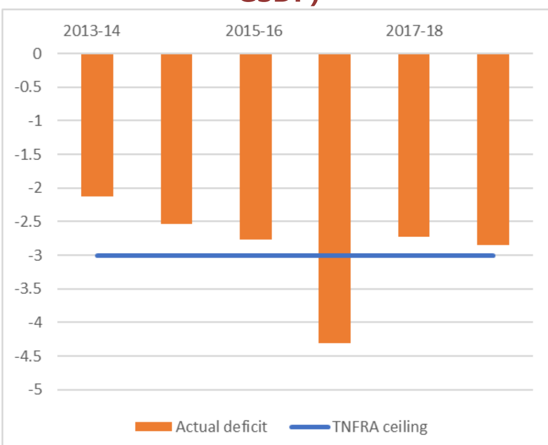
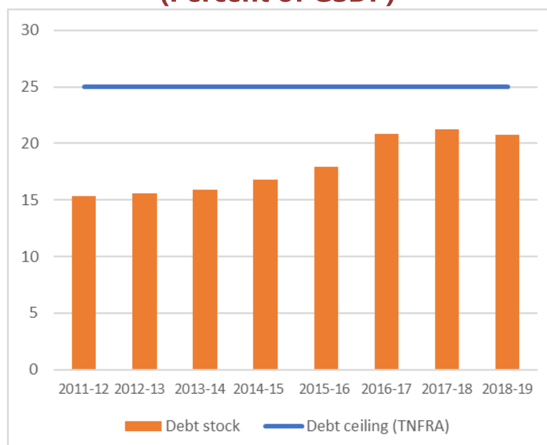


Figure 4. Debt Stock (Percent of GSDP)



Sources: Comptroller and Auditor General (CAG) until 2017/18; MTFP appended to the 2019/20 budget (revised estimates for 2018/19)

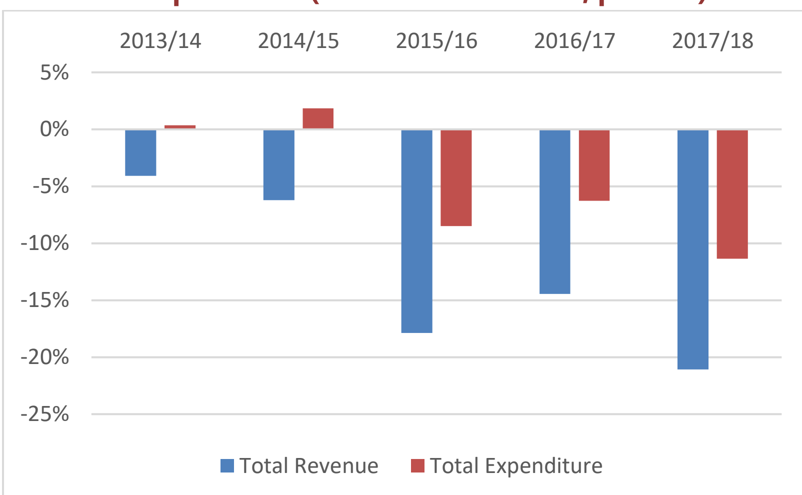
4. TNFRA also provides for a Medium-Term Fiscal Plan (MTFP). Section 4 of TNFRA states that the MTFP shall set a multiyear rolling target for the main fiscal indicators and shall include the specification of underlying assumptions. It shall also contain (1) elements on fiscal performance in the previous year and in the current year vis-à-vis the past MTFP, (2) a statement on recent economic trends and future prospects for growth, and (3) elements on main fiscal policies both on the revenue and the expenditure side.

[5] Fiscal deficit is defined in TNFRA as "the excess of total disbursements of the Consolidated Fund of the State (excluding repayment of debt) over total receipts into the Consolidated Fund excluding the debt receipts during a financial year." Debt, or "total liabilities," is defined as "the liabilities under the Consolidated Fund of the State and the Public Account of the State." The definition is the same as the one contained in the India Fiscal Responsibility and Budget Management Act (2003,) which sets the overarching framework and fiscal rules for the Central State and the State governments.

[6] They also provide for a type of golden rule, whereby the revenue deficit has to be eliminated, that is, revenue receipts have to be higher than revenue expenditure.

5. In practice, the MTFP suffers from several shortcomings. It provides projections two years beyond the next year's budget; these are known as "advanced estimates" (AE) for main revenue and expenditure items. However, the most recent MTFP appended to the 2019–20 budget does not provide much detail, notably, on the assumptions underpinning the macroeconomic and macrofiscal scenario until 2021/22. In particular, growth assumptions (nominal growth increasing from 8 percent in 2019/20 to 10 percent in 2020/21 and 2021/22 are not presented and defended explicitly. Policy assumptions and choices on the expenditure and the revenue side are not detailed, either. Overall, the MTFP preparation and submission seem to aim more at complying with a legal requirement rather than at providing a strategic framework for the overall budget formulation process. This is apparent in the very significant discrepancy both on the revenue and the expenditure sides between AE and actual outturns, as shown in **Figure 5**. Moreover, the track record has worsened in the most recent years, with revenue collection typically 15–20 percent lower than advanced estimates.[7]

Figure 5. Deviations between Advanced Estimates in Year t-2 and Outturns for Revenue and Expenditure (Advanced Estimates, percent)



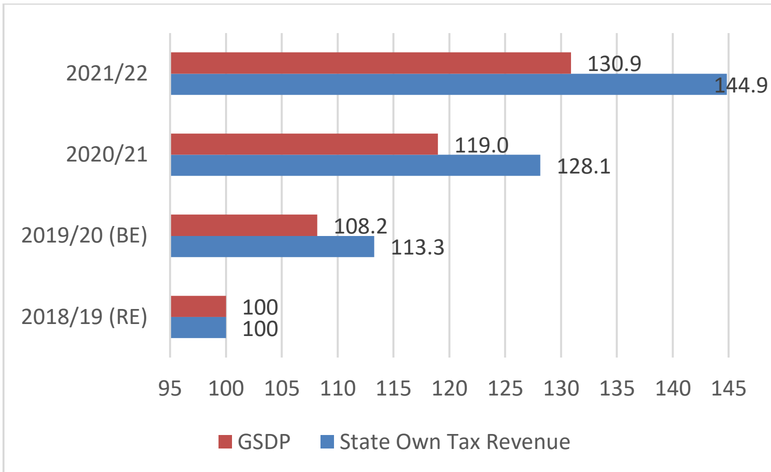
Source: Mission, based on FD data for Revenue Receipts and Revenue Expenditures.
Note: Positive numbers indicate that actuals exceeded advanced estimates from t-2.

6. These shortcomings are partly due to limited capability to undertake macroeconomic and fiscal forecasts. Although the Directorate for Economics and Statistics in the Planning Department produces estimates of GSDP twice a year in July and January, no entity within the State is tasked with producing a macroeconomic framework for the State and assessing its fiscal implications.[8] The GSDP and fiscal projections currently derive from an iterative process whereby the

[7] Lekha Chakraborty, Pinaki Chakraborty, and Ruzel Shrestha. 2019. "Budget Credibility of Subnational Governments: Analyzing the Fiscal Forecasting Errors of 28 States in India." Report No. 280, National Institute of Public Finance and Policy, New Delhi, September 6, confirms the revenue forecasting errors.
[8] Tamil Nadu's Planning Department does not produce a regular annual Economic Survey, unlike most other Indian States.

Finance Department (FD), after taking into account expenditure requests, adjusts revenue forecasts to a level consistent with broad fiscal targets. This process may lead to inconsistencies, such as for the State Own Tax Revenue (SOTR) scenario contained in the MTFP 2019–22, which provides for a nominal growth of 13 percent per year, even though nominal GSDP growth is consistently much lower over the whole period **(Figure 6)**. In the absence of detailed explanations for the high tax buoyancy, this scenario lacks credibility, especially considering the downward pressures on liquor taxes that make up 20 percent of the SOTR.[9]

Figure 6. State Own Tax Revenue and GSDP Growth in the 2019/–22 MTFP



Source: MTFP attached to 2019/20 budget.

Note: BE = Budget Estimates; RE = Revised Estimates; 2018/19 figures = Base 100.

Challenges

7. Tamil Nadu should introduce a Medium-Term Fiscal Framework (MTFF) to enhance its fiscal planning capacity. A MTFF is an institutional framework for setting aggregate multiyear fiscal targets or objectives within a projected macrofiscal environment, which can then be used as a reference during the budget formulation process. Key components of a MTFF include (1) a set of realistic and consistent medium-term macrofiscal projections, (2) a medium-term fiscal strategy to be described in a specific document (see **I.B**), and (3) a comprehensive assessment of the potential impacts of fiscal risks (see **II**). Taken together, all of these elements would enable Tamil Nadu to appropriately steer fiscal policy, assess the need for further expenditure or revenue reforms, and communicate effectively to investors,[10] businesses, and citizens. They would provide a solid

[9] The Tamil Nadu Authorities have ordered the closing of 500 shops of the local alcohol State monopoly and restricted opening hours to curtail the consumption of alcohol.

[10] For example, through access to a Tamil Nadu Public Finance internet portal providing a high-level presentation of the Tamil Nadu fiscal strategy and access to other relevant documents.

foundation on which to build a strategic budget formulation process with a strong top-down and multiannual dimension (see **I.B**).

8. **Prerequisites for the implementation of an MTFF include sound methods for macrofiscal analysis and forecasting, as well as adequate and transparent procedures.** Priority should be given to (1) developing stronger methodologies and analyses, and (2) setting formal processes for the preparation of the MTFF projections and underlying fiscal strategy.

9. **Simple macrofiscal methodologies can be used to estimate the resource envelope and available fiscal space in time for budget preparation.** Excel-based templates could be sufficient in the initial stages, because Excel includes basic regression tools that allow simple correlations and assessment of buoyancy. These templates can grow into more advanced forecasting models, making use of statistical software. SARTTAC's course on developing a macrofiscal forecasting tool for State governments would be useful in this respect.

10. **Several analyses should be undertaken on a regular basis to set the stage for a fully-fledged MTFF.**

- ***Understanding macrofiscal linkages:*** These are economic interactions between the macroeconomic and the fiscal dimensions. Assessing these linkages is critical to ensure consistency in the macrofiscal framework and to support the policies underpinning the fiscal strategy. In practice, this means analyzing historical fiscal data series—neutralized from major discretionary changes,—identifying long-term correlations with relevant macroeconomic indicators and assessing buoyancy and fiscal multipliers.

- ***Explaining forecast revisions and deviations:*** Instead of having to start from scratch, detailing the reasons behind forecast revisions highlights all of the changes since the last forecast vintage of historical data and shapes the narrative on the causes of deviation between historical vintages. Analyzing the gap between forecasts and actuals helps to improve forecasting methods and reinforces the credibility of forecasts. This analysis is especially relevant in Tamil Nadu, given the track record of past MTFPs when compared to actuals.

- ***Addressing macroeconomic uncertainty:*** The preparation and publication of sustainability analyses and alternative scenarios would help to illustrate the inherent volatility of macroeconomic indicators and its fiscal consequences.

11. **In terms of process, macrofiscal planning requires strong coordination.** It draws on numerous data sources, for example, historical macrofiscal data, in-year disbursement/collection data, macroeconomic projections, and information on current and future policy decisions. This process represents a large amount of data produced by different agencies (for example, various parts of the FD, Directorate for Economics and Statistics, Directorate for Evaluation and Applied Research in the Planning Department, and Commercial Tax Department), which can only be gathered and utilized in a timely manner if there is strong coordination.

12. The FD should assume this coordination role within the framework of a cross-departmental committee that is to be established and that requires clear deadlines, shared assumptions, and sound data management practices.

- ***A calendar for the macrofiscal planning process*** that is shared well in advance of the forecast preparation helps to clarify what is expected of each stakeholder. The calendar should (1) leave sufficient time for the whole process to allow for detailed analysis and consistency checks; (2) provide for a number of updates leading up to the presentation of the budget proposal; (3) offer a sequencing of data exchanges—both to and from the FD—consistent with the calendar of important data releases. This internal calendar could ultimately become part of a wider-ranging budget circular, covering both the preparation of the MTFF and of the annual budget.

- ***Key assumptions underlying the planning exercise*** should be shared by the FD with all stakeholders from the start to avoid inconsistencies. A standard format for these key assumptions would facilitate communication when new information has to be shared. Final assumptions should then ideally be disclosed to the public to support the credibility of the forecasts.

- ***Data management arrangements*** should be set by the FD to preserve the integrity of the forecasting process, notably, with a repository of all assumptions and forecasts attached to a specific vintage of historical data to facilitate subsequent comparisons or references.

13. Sensitization of the whole administration to the usefulness of the planning process is critical. Raising awareness at senior levels is required to make the MTFF a solid anchor of the budget preparation process. Regular memorandums on the space for new policies or on forecast revisions could help to demonstrate the power of the framework in terms of policy framing and storytelling. Finally, technical-level staff should receive training on the benefits of a macrofiscal planning process to sound budget preparation, as well as on tools to develop forecasting capacity.

Recommendations

a. Short term

- FD should identify staff for a macrofiscal unit.
- BD should develop the capacity, supported by SARTTAC, to create a macrofiscal capability within the FD.

b. Medium term

- FD should implement a medium-term fiscal framework to anchor the overall budget formulation process.

B. Annual and Medium-Term Budgeting

Budget formulation process

Current situation

14. Budget formulation in Tamil Nadu benefits from some underlying strengths. Fiscal management has been relatively conservative, and the fiscal rules set by TNFRA have broadly been complied with. The FD is equipped with experienced and skilled staff, with career paths enabling a well-developed system of mentorships. The FD also enjoys a strong institutional standing vis-à-vis line departments, and the annual budget circular that sets the stage for the annual budget formulation process is clearly written.

15. Tamil Nadu follows a traditional budget formulation process, characterized by annual, bottom-up, and incremental budgeting. Budget rules in Tamil Nadu are largely captured in a budget manual dating back to 1992 that emphasizes a control function for FD rather than a strategic prioritization role.[11] The scope of the budget preparation process is limited to the upcoming fiscal year.[12] No ex ante ceilings, whether indicative or binding, are set by FD to provide a framework for the budget requests of other departments. Moreover, the budget process is incremental, based on line item budgeting; it does not evaluate existing performance but rather focuses on new schemes and measures. Some documents known as "performance budgets" are published by line departments, but these are unrelated to budget estimates and are not reviewed by FD.

16. This budget formulation process has served the State reasonably well so far, but its limitations are being felt. The traditional budget formulation process was appropriate in a period of high growth and inflation, but it is less so now. The inadequacies of the current budget preparation process have become more pressing in recent years. The increase in the share of nondiscretionary expenditure and the uncertainties on revenue growth limit fiscal space. Adequate prioritization and thorough evidence-based discussion of expenditure priorities are required to address this trend. Doing so is not possible in the current, purely incremental budget formulation process, which is largely disconnected from actual budget outturn and performance against policy objectives.

[11] The authorities plan to revise the manual because it has several outdated references to the High Commission for India in London and because of the need to round expenditure to the nearest Great British Pound.

[12] According to the annual budget circular, line departments have to submit spending requests for the next fiscal year (budget estimates) and the two subsequent years (advanced estimates). The mission, however, has been advised that advanced estimates are of very poor quality and are not subject to any real discussion between the Finance DD and the other departments.

17. **A compressed calendar leaves inadequate time to prepare a robust budget.** The Tamil Nadu budget calendar essentially spans five months from September–January from the publication of the budget circular to the preparation of the budget speech. Departments have only three weeks in September to prepare their budget requests for transmission to the FD. This timeframe is hardly sufficient to provide credible estimates and costing of new measures.[13]

18. **The budget framework is undermined by frequent supplementary budgets and reappropriations.** The challenge of annual budgeting is compounded by the absence of strategic planning; departments routinely launch new schemes through announcements after the budget preparation process.[14] The State of Tamil Nadu routinely prepares two to three supplementary budgets every year; work on a first supplementary budget often starts within the first quarter of the new fiscal year, which reinforces the lack of credible estimates. This practice contradicts international good practice—which recommends one supplementary budget in a given fiscal year, tabled in the Legislature. after the midyear point. Further revisions should only be considered for unforeseen and unavoidable circumstances.

19. **Budget discussions do not focus on strategic priorities and fail to examine performance or quality of spending.** The Decentralized Budget Meetings (DCBs) between sectoral units of the budget wing and line departments usually occur in October. They are mainly used to discuss spending estimates for the current and next financial years for existing schemes, as well as the cost of new policy initiatives (Tamil Nadu Innovation Initiatives, or "Part II schemes"). Performance information is not used in this discussion, nor is there any assessment of the "value for money" of existing and proposed schemes. The discussion centers on the accuracy of the technical assumptions underpinning the budget requests, focusing on inputs in terms of staff and other operating or capital expenditures. This approach is insufficient to form a strategic judgment of the quality of spending.

20. **The poor quality of budget discussions is largely due to the absence of spending ceilings, resulting in a time-consuming process to reduce budget requests within the available resource envelope**. An iterative process is required to reduce the gap between requests from spending departments and realistic budget estimates. Spending departments are best equipped to identify projects within their mandate, while the FD's role is best confined to evaluating the quality of the spending proposals and checking the consistency of the estimates.

[13] In line with international good practice, line departments should be given at least two months to prepare their budget proposals, from the day the budget ceilings are communicated by the Ministry of Finance.

[14] The Directorate for Special Program Implementation, in charge of monitoring the delivery of policy announcements made by the GoTN, tracked 10,000 announcements between 2011 and 2019; the majority of these announcements was made by line ministers, only 7 percent was made during the budget speech.

21. Under these circumstances, only makeshift measures, such as expenditure control, accumulation of arrears, and off-budget borrowing, can be used to meet fiscal targets. The lack of accuracy in the budget formulation process is evident both on the revenue and the expenditure sides. Over the past four years, revenues are lower than budget estimates by 4 to 10 percent **(Figure 7)**. Expenditures are also—with the exception of 2014–15—significantly lower than authorized appropriations. Nevertheless, Tamil Nadu managed—with the exception of the impact of the UDAY scheme in 2016–17—to achieve its headline fiscal balance targets **(Figure 8)**. Rather than indicating sound financial management, this practice demonstrates the ability of the FD to control in-year budget execution by combining various expenditure control practices, such as shortfalls in contributions to various funds, or by accumulation of arrears to Public Sector Undertakings (PSUs), such as the electricity generation company (see **II.A**). As regards the debt stock indicator, however, off-budget financing is captured in the evolution of the debt stock, owing to the broader definition of the debt stock that is not limited to liabilities accruing to the Consolidated Fund.

Figure 7. Deviations between Budget Estimates and Outturns for Revenue and Expenditure (in percent of budget estimates)

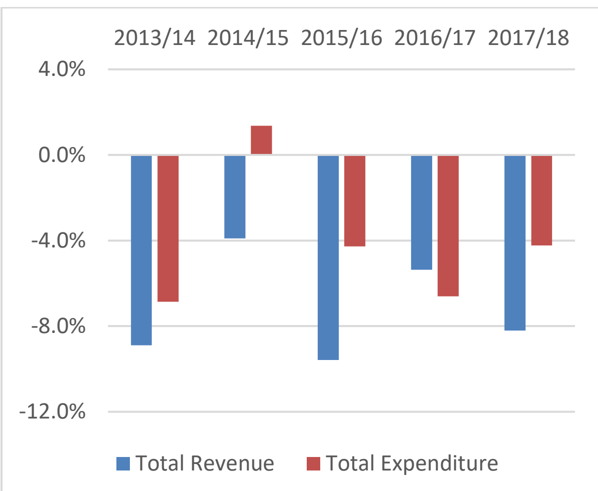
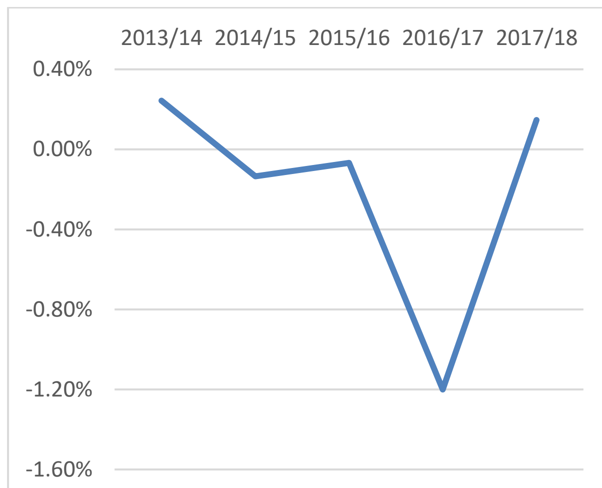


Figure 8. Deviations between Budget Estimates and Outturns for Fiscal Balance (in percent of GSDP)



Source: Based on MTFP database of FD from 2013/14 – 2017/18 .
Note: Positive numbers indicate that actuals exceeded budget estimates.

22. The current process does not contribute to a sustainable fiscal path, given the looming fiscal risks from revenue reductions and spending pressures. Tamil Nadu faces increasing fiscal risks, both in the short-term and long-term (see **II.A)**. Slower revenue and expenditure growth will limit the State's ability to satisfy citizens' service delivery demands. Sustainability risks are apparent from the limited safety margin vis-à-vis debt and deficit ceilings (see **Figure 1 in I.A**) and in the deterioration of the coverage ratio of revenue receipts to revenue expenditures. Whereas the State is not allowed to run a revenue deficit[15] under the Tamil Nadu Fiscal Responsibility Act, the State now covers only around 85 percent of its expenditure with revenue receipts, down from 98 percent as recently as 2013–14 (**Table 2**).

Table 2. Evolution of the Revenue Deficit

(bn INR)	2013/14	2014/15	2015/16	2016/17	2017/18
Total revenue receipts	1,080	1,224	1,290	1,402	1,463
Total revenue deficit	-18	-64	-120	-130	-216
Revenue deficit (% of total receipts)	-1.7	-5.2	-9.3	-9.3	-14.8

Sources: Mission calculations; data from Finance Department.

23. **Committed revenue expenditure is increasingly limiting the fiscal space for infrastructure spending.** The weight of "committed expenditure" (nondiscretionary expenditure, such as wages, pensions, and debt interest) has strongly increased over the past few years and now represents more than 63 percent of total revenue expenditure (**Table 3)**. This composition of spending reduces margins for new schemes and for capital expenditure and calls for a renewed approach to budgeting to actually cut spending or curb expenditure growth.

Table 3. Evolution of the Share of Committed Expenditure in Total Revenue Expenditure

(bn INR)	2013/14	2014/15	2015/16	2016/17	2017/18
Committed Revenue Expenditure	665	753	833	948	1,063
Total Revenue Expenditure	1,098	1,288	1,410	1,532	1,679
Committed Expenditure to Total (%)	60.6	58.5	59.07	61.9	63.3

Source: Comptroller and Accountant General Report 2017/18 reviewed by Finance Department

24. **The introduction of a new information technology (IT) system presents an opportunity to modernize budget formulation.** Efforts already mentioned in the 1992 budget manual to supplement incremental budgeting by applying zero-based budgeting to various policy areas seem to have had little traction. However, a new Integrated Financial and Human Resource Management System (IFHRMS) is being developed and will provide a platform for real-time data collection both on payroll and non-payroll expenditures. IFHRMS will enable automated budget submissions—minimizing errors from manual estimates and facilitating increased scrutiny.

Challenges

25. **Restoring the credibility of the annual budget should be the first priority**. Doing so means ending the practice whereby the FD focuses so much energy on budget execution and control that it has little time for a well-run budget preparation process. The current process leads to unnecessarily complex budget execution. Credible budget preparation is a prerequisite for the

[15] The revenue deficit measures the difference between so-called "Revenue Receipts" (tax revenue, non-tax revenue, grants in aid, and contributions received) and Revenue Expenditures (general services, social services, economic services, grants in aid, and contributions disbursed). As such, it indicates the balance between revenue and expenditure, excluding capital expenditure and financial operations (loans and advances granted or recovered, debt repayment).

success of other reforms, such as the introduction of top-down budgeting and (later) medium-term budgeting.

26. A longer budget calendar would allow more time to prepare and discuss realistic budget estimates. An earlier start, giving more than a few weeks to line departments to prepare their spending estimates and budget requests, would help to increase the quality of budgeting, especially if the process is anchored in a strong top-down dimension.

27. Policy planning should be properly articulated with the budget formulation process. The budget has to fully play its role as a vehicle to accurately determine and authorize the fiscal consequences of the government's policies. Doing this requires a strong capacity for policy planning[16] and support at the highest political levels to ensure that initiatives with significant financial impact are presented through the normal budget formulation process. Consulting with the Cabinet on priorities through a Fiscal Strategy Statement very early in the budget process could help to ensure a level of discipline among line departments.

28. A contingency reserve or planning margin could be established for new initiatives to provide flexibility. A Tamil Nadu Contingency Fund of INR 1.5 billion, or less than 0.1 percent of total expenditure, already exists in the budget. Although this fund may handle some limited unforeseen expenditure, it is not appropriate for substantial policy priorities that emerge during the fiscal year. An adequate contingency reserve would amount to 2 or 3 percent of total expenditure.[17] Its rules of engagement should be carefully designed so that allocating the contingency reserves does not turn into an alternative budget preparation exercise (See **Box 1** for more details on the role and size of contingency reserves.).

[16] Tamil Nadu Vision 2023 – Strategic Plan for Infrastructure Development in Tamil Nadu (February 2014) document already provides an overarching strategic framework covering six major sectors (energy, transport, industrial and commercial infrastructure, urban infrastructure and services, agriculture and human development).

[17] See, notably, IMF. 2018. *Fiscal Transparency Handbook*. Washington, DC: IMF.

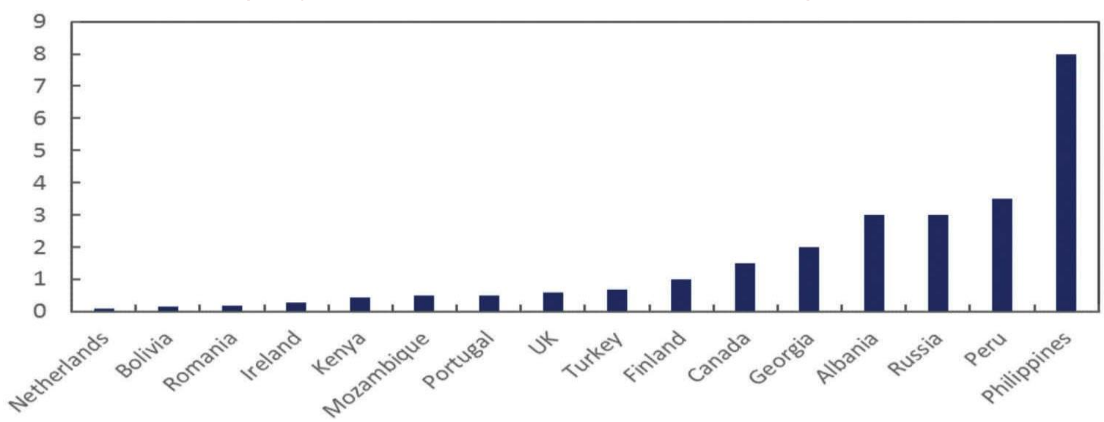
Box 1. International Experience with Contingency Reserves

A Contingency Reserve is a mechanism to address uncertainties during in-year budget execution, notably, linked with fiscal risks. It may take several forms. In many countries, it is an unallocated appropriation in the annual budget law. In other countries, it is a fund with an appropriate amount of financing authorized under the legal framework and replenished at the beginning of each fiscal year, depending on the drawdown during the previous year. The benefit of such an appropriation is that urgent but unforeseen needs can be met without seeking additional appropriations or having to cut spending elsewhere, which may lead to the accumulation of arrears.

Issues of attention in the design of a Contingency Reserve include the following:

- ***Access criteria:*** There should be transparent criteria in place governing the circumstances under which a given department may access appropriations from the Contingency Reserve; eligibility should only be considered for unforeseen expenditure and not for expenditure needs resulting from lack of adequate planning.
- ***Role of the FD:*** The FD should have a role as gatekeeper and ensure that the Contingency Reserve is not used to circumvent decisions on expanding or creating new schemes not funded during the earlier budget formulation process.
- ***Reporting:*** Transparent reporting will ensure accountability to the legislature and to the wider public, and it will help the FD to uphold the access criteria as defined in legal regulations.
- ***Size:*** The size of the contingency reserve should not be so large as to undermine budget discipline or so small as to be consistently exhausted part way through the year. In most countries, this size implies a contingency appropriation of between 1 percent and 3 percent of total budgeted expenditure **(Figure 1.1).**

Figure 1.1. Size of Contingency Reserves in Selected Countries (Percentage of Total Expenditure)



Sources: IMF Fiscal Transparency Handbook, with data from Fiscal Transparency Evaluations; OECD Budget Practices; and country budget documentation.

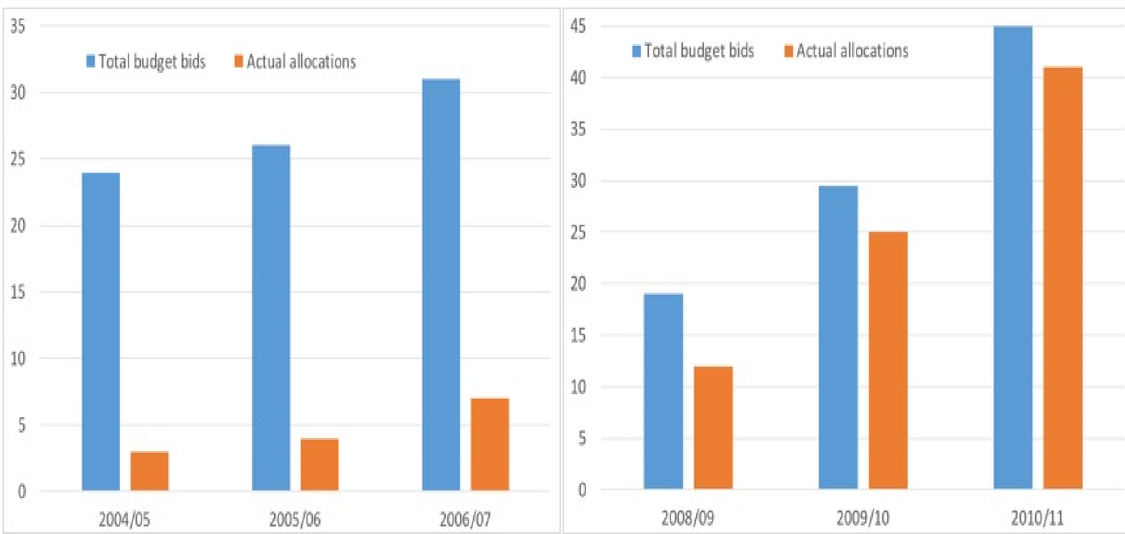
29. **Determining ceilings at the beginning of the budget formulation process would put the onus on spending departments to prioritize their expenditure.** In such a top-down process, expenditure ceilings would be derived from the first year of the MTFF (see **I.A**), with the ex-ante breakdown of the aggregate MTFF expenditure ceiling across departments determined by an internal FD exercise, taking into account expenditure pressures and policy priorities endorsed by the Cabinet.

Although strict adherence to ceilings is unlikely to be immediate, experience shows that compliance normally increases year after year once departments become used to the new system. It is important to make sure that departments trying to "game the system" and get more than their allocated ceiling are not rewarded; otherwise, this practice could introduce moral hazard in the top-down budgeting process. **Figure 9** shows the impact of a well-functioning top-down budgeting mechanism, as opposed to a comparable bottom-up method; the discrepancy between budget bids and available resources is much lower, if not absent, as departments do their own prioritization to respect their ceilings.

Figure 9. Top-Down versus Bottom-Up Budgeting

1. Bottom-Up Budgeting: South Africa, 2004 MTEF (SAR, billions)

2. Top-Down Budgeting: United Kingdom, 2010 Spending Review (GBP, billions)



Source: IMF Mission.

30. A shift to top-down budgeting would help to change the nature of budget discussions and refocus the FD on its budget challenge function. The FD should investigate and scrutinize the policy and expenditure choices of other public entities, with the aim of aligning these with wider government objectives and ensuring "value for money," not only compliance with financial management rules. Successful examples of exercising the budget challenge function in Tamil Nadu already exist, such as the role of the FD in encouraging the outsourcing of maintenance in public hospitals. Further diffusion, however, requires expansion of the skill set of FD officials and improvement in the tools available to them for costing and measuring the impact of public policies. **Annex II** explains in more detail how the budget challenge function can be developed.

31. A clear political mandate is required to implement top-down budgeting. A Cabinet-level discussion of the basis of a concept paper explaining the implications of top-down budgeting for policymaking and policy implementation is necessary to ensure that the transition to top-down budgeting is fully "owned" by the full Cabinet, as well as by the FD and the Minister of Finance.

32. These reforms could be piloted to the local context before full-scale implementation. One or two departments could be identified to pilot the new approach: a trade-off in terms of budget flexibility (more freedom to redeploy and manage appropriations) and resource predictability, on the one hand, against a strong commitment to respect the allocated budget and to meet some performance targets, on the other hand. Experience shows that relatively mature service delivery administrations are usually well-suited for a piloting role. In discussions with the mission, the Department of Industry indicated its readiness to participate in such a pilot.

33. The introduction of medium-term budgeting would further improve the budget formulation process. The main advantages of a Medium-Term Budget Framework (MTBF) with ceilings per policy area or administrative department are threefold: (1) ensure the predictability of resources to line departments over a longer time horizon; (2) show more clearly the shifts in the allocation of resources that reflect changes in political priorities; (3) allow for better decision-making by making more visible the medium-term impact of savings measures or new projects. A MTBF also facilitates the work of the FD and its dialogue with line departments, with outer year budget figures serving as a starting point for the construction of the budget in the following year.

34. However, the prerequisites of medium-term budgeting are not yet in place. In this context, continuing to ask line ministries to systematically provide AE for their spending while not using them makes little sense. The FD could usefully restrict this request to the most important spending schemes and start an internal exercise to develop its own vision of how resources should be allocated for line ministries over the medium term. This process would emulate the practice in most countries, where the budget department often had extensive experience with internal medium-term projections of expenditure before transitioning to a full MTBF.

35. The evolution to a new model of budgeting needs to be captured in the FD's tools. This would require a thorough overhaul of the 1992 budget manual. Adjustments to the IFHRMS may also be needed to ensure consistency with a top-down approach and with the increased managerial freedom granted to line departments. **Annex II** suggests a new budget calendar in line with the requirements of this reformed budget formulation process.

Recommendations

a. *Short term*

- FD should introduce an extended budget calendar, whereby an early phase (April-June) would be devoted to an internal exercise to develop its own vision of the next year's budget divided per big policy areas, in light of overall fiscal constraints and policy orientations.
- FD should introduce a budget challenge function to improve the credibility of annual budget estimates.

b. *Medium term*

- FD should seek political mandate for a transition to a top-down budgeting process.

- FD should pilot the process with more responsive departments and provide predictable resources in exchange for commitments, in terms of policy outcomes, to respect ceilings and minimize reallocations.
- FD should gradually introduce medium-term budgeting once annual budget estimates improve.

Budget Documents

Current Situation

36. Tamil Nadu produces comprehensive budget documents that are technical and detailed. Most of the documents can be downloaded from the Government of Tamil Nadu (GoTN) website. The documents contain significant volumes of numbers but are not user friendly and lack analysis and policy focus. Historical trends are not provided to determine the relationship to proposed estimates. Many of the documents follow the Union government format, including the annual financial statements, demand for grants, budget speech, and introduction to the budget.

37. The budget documents prescribed by the budget manual and TNFRA include the following:

- **Annual financial statement**: the budget of the State that contains estimated revenue and expenditure for the financial year
- **Demand for grants**: detailed budget estimates for 56 demands (separate volumes)
- **Introduction to budget**: explanation of the structure, procedure, and scope for budgeting to help readers understand terms and expressions used in budget documents
- **Budget memorandum**: explanation of the overall budget allocations
- **Appendices to budget memorandum**: 22 appendices that provide estimates for such areas as loans, guarantees, salaries, schemes, transfers to local government, and gender budgets
- **Budget speech**: outlines the policies of government for the budget year
- **MTFP (appendix to budget speech)**: provides a rolling target for fiscal indicators, including revenue deficit, fiscal deficit, and debt-to-GSDP
- **Appropriation bill**: approves the annual budget estimates
- **Policy notes**: provide further details on departments' policy objectives
- **Performance budgets**: contain information on outcomes, inputs, activities, and some outputs.

38. At present, there is no comprehensive document that describes the budget policy and supporting allocations. The Open Budget Survey prescribes four key budget documents to improve budget transparency. These include a pre-budget document or fiscal strategy statement, the executive's budget proposal, an enacted budget, and a citizens' budget. Despite the voluminous documents prepared, Tamil Nadu does not prepare a pre-budget document or concise citizens' budget. The State prepares demands for grants (budget proposal) and an enacted budget (appropriation).

Challenges

39. Best practice is to produce a fiscal strategy report early in the budget process to guide and constrain the upcoming budget discussions. Countries that produce early fiscal strategy reports have set themselves a measurable objective for fiscal policy and engaged with the difficult trade-ofLes that are implicit in that objective (**Box 2**). The early production of the fiscal strategy also empowers the budget officers responsible for developing the budget to engage with the Cabinet on the approach for the coming budget. This interaction between the technocrats and political authorities can improve the alignment of the budget with the government's priorities and give the FD a mandate to prepare the budget in line with the proposed strategy. It provides a sound basis for a well-functioning top-down process as outlined in the previous section.

Box 2. Country Examples of Fiscal Strategy Reports

- **New Zealand** publishes a *Budget Policy Statement* at the end of the sixth month of the fiscal year, agreed to at the ministerial level. The statement includes explicit deficit and debt targets and outlines key macroeconomic assumptions for the next budget. It sets priorities for the budget and also sets out the government's medium-term fiscal strategy. Projections are formulated for the current fiscal year, the budget year, and three forward years.

https://treasury.govt.nz/publications/budget-policy-statement/budget-policy-statement-2019

- **South Africa** publishes a *Medium-Term Budget Policy Statement* and tables it in Parliament five months before the presentation of the annual budget proposal. It is a government policy document that communicates to Parliament and the country the economic context in which the forthcoming budget will be presented, with fiscal policy objectives and spending priorities over a three-year expenditure period. It provides medium-term estimates for key macroeconomic indicators (such as GDP, inflation, consumption, investment, and exports/imports) and fiscal aggregates (total revenue, total expenditure, and interest costs).

http://www.treasury.gov.za/documents/mtbps/

- **Indonesia** produces a Fiscal Policy and Macroeconomic Framework seven months ahead of the start of the budget year. It includes a description of the macroeconomic framework and of fiscal policies and priorities, deficit targets, revenue projections, and proposed expenditure ceilings for the upcoming budget. It provides an estimation of fiscal space over a three-year period. On the basis of this document, pre-budget discussions are held in Parliament, leading to fixed points for revenue forecasts and economic assumptions, thereby anchoring the rest of budget preparation.

http://www.fiskal.kemenkeu.go.id/data/document/kem/2019/kem_ppkf_2019/files/kem_ppkf_2019.pdf

Source: Mission.

40. The authorities could build on existing documents and produce a comprehensive fiscal strategy report by late August. To fully reach its goals, such a report, often known as a "pre-budget statement," should be published when the aggregate resource envelope has been determined. It is a key deliverable in the context of a fully-fledged MTFF/MTFP. The fiscal strategy report should contain at least: (1) a description of the macroeconomic environment of the previous, current, and forward years; (2) a description of the fiscal outturns in the previous year and of revised fiscal estimates for the ongoing year, and their underlying assumptions; (3) the presentation of medium-term fiscal targets for broad aggregates and underlying assumptions, along with some narrative about the available fiscal space and the fiscal policy measures envisaged for the medium-term; (4) aggregate and sectoral expenditure ceilings for the budget year; and (5) qualitative and quantitative assessment of fiscal risks. It should also give an overview of how expenditure is aligned with service delivery needs and government priorities. Past fiscal outcomes should be reconciled with plans, and deviations should be explained. When mitigating actions resulting from deviations and plans are required, these should be clearly explained.

41. A proposed outline for the fiscal strategy report can be found at Annex III. Forecasts from the previous fiscal strategy document should be systematically provided as a reference, along with explanations on revisions and deviations (see **Box 2** for useful country examples).

42. A citizens' budget could be produced alongside the budget. Tamil Nadu's current budget speech and budget highlights present a good basis for producing a citizens' budget. Many countries are communicating the key budget decisions and spending priorities in simple terms and in local languages to citizens. The citizens' guide should be brief; should include visual aids such as charts, diagrams, photographs,; and should use non-technical language. The document can be easily produced for the next year's budget and could be printed in color and uploaded to the website. **Box 3** provides more guidance on citizens' budget formats.

Recommendations

a. Short term

- Publish a brief citizens' budget alongside the budget 2020–21.

b. Medium term

- Develop a fiscal strategy report based on the macrofiscal forecast with budget 2021–22. Gradually improve the quality and content of the report.

Box 3. A Citizens' Budget

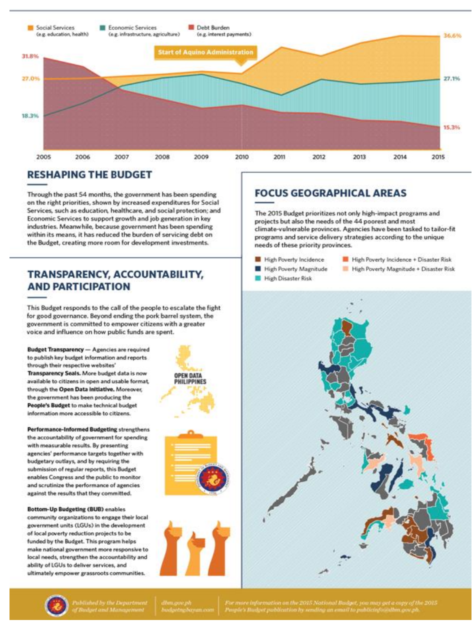
A citizens' budget is a nontechnical presentation that can take many forms; it is designed to reach and be understood by as large a segment of the population as possible. It is essential that governments be proactive in helping the general public make sense of the budget. Broadening understanding of the country's public finances can help frame more realistic citizens' expectations and build support for difficult choices. It can also help to offset the influence of narrow special interest groups and avoid public debates being conducted in jargon by technocrats**.**

The relevant principle under the IMF Fiscal Transparency Code[18] states that a citizens' guide to the budget would enable all interested citizens to conveniently obtain key information on fiscal policies. Basic practice requires governments to publish accessible information summarizing the economic and fiscal projections, as well as the main policy initiatives, with a discussion of their impact on the average citizen.

An annual budget is typically the key instrument by which a government translates its policies into action. Accordingly, budgets should not only be available to the public; they should also be accessible to the public.

However, the annual budget is normally long and complex and accompanied by a number of detailed supporting documents. Even for technical experts, understanding the budget can be a difficult and time-consuming task. A government's citizen budget should focus on the objectives and contents of the budget rather than its process. It should meet a range of quality standards, including comprehensiveness, objectivity, relevance, reliability, ease of understanding, and timeliness.[19] It should also be disseminated at the same time that the government presents the annual budget to the legislature so that the public is engaged in the discussion in time to have an impact on the legislature's deliberations on the budget.

Example of the Philippines:



Source: *https://www.internationalbudget.org/open-budget-survey/resources-for-governments/citizens-budgets/examples/*
In addition: https://www.dbm.gov.ph/index.php/budget-documents/2018/2018-people-s-budget/

Source: Murray Petrie and Jon Shields. 2010. "Producing a Citizens' Guide to the Budget: Why, What and How?" *OECD Journal on Budgeting*

[18] IMF. 2018. *Fiscal Transparency Code*. Principle 2.3.3. Washington, DC: IMF.

II. FISCAL RISK MANAGEMENT

A. State Government's Exposure to Fiscal Risks

43. Fiscal risks are factors that may cause fiscal outcomes to deviate from expectations or forecasts. These factors include potential shocks to government revenues, expenditures, assets, or liabilities that are not reflected in the government's fiscal forecasts or reports. In addition to macroeconomic risks (for example, unexpected variance in GDP or inflation), fiscal risks also arise from specific sources—such as the realization of contingent liabilities or other uncertain events, including natural disasters, the bailout of a troubled public corporation by the government, or the collapse of a bank. Each of these events can entail both immediate and/or ongoing costs to the government because of their explicit obligations (liabilities that have a legal or contractual basis) or implicit obligations ("insurer of the last resort").[20]

44. This chapter of the report discusses the main sources of specific fiscal risks in Tamil Nadu, the challenges in managing these risks, and recommendations to reduce them. The main topics are fiscal risks from public corporations; risks to revenues; and a range of other specific fiscal risks from public debt, expenditure arrears, guarantees and other explicit contingent liabilities, PPPs, and disasters and climate change. The final section deals with management and reporting of fiscal risks.

B. Public Corporations

Current Situation

45. Based on current trajectories, the finances of some large PSUs[21] are on an unsustainable path, despite receiving significant fiscal support from the Tamil Nadu government. PSUs in the electricity and transport sectors have been experiencing large losses for a number of years, despite receiving significant annual and exceptional fiscal support (**Figure 10)**. In 2016–17, under the Government of India (GOI) UDAY scheme, the Government of Tamil Nadu loaned INR 228 billion to TANGEDCO as an interest-free loan, to be converted to a grant over five years. This action added 1.8 percent of GSDP that year to the fiscal deficit. The expectation is that these losses will continue unless there are significant policy changes.

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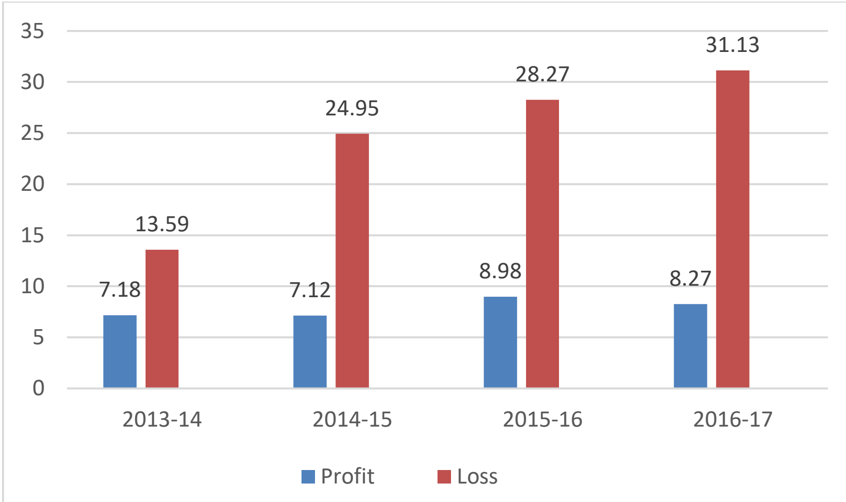
[20] Implicit obligations are not established by law or contract but are based on a moral obligation of the government that reflects public expectations and interest-group pressures.

[21] Public corporations are classified as PSUs (for example, the Passenger Transport Group) and Statutory Bodies (for example, TANGEDCO). Both types are corporations established under the Companies Act. For ease of reference, they are referred to in this report as *PSUs*.

As noted in **IA,** the fiscal space within the statutory deficit and debt ceilings has shrunk progressively since 2013–14, and there is limited ability to accommodate further deficits or another exceptional assumption of PSU debt.[22]

Figure 10. PSU Profits and Losses 2013–14 to 2016–17 (INR, in billions)



Sources: Review of Performance of State Public Sector Undertakings and Statutory Bodies for the year 2016–17; Bureau of Public Enterprises, Finance Department, undated (most recent report).

46. A major driver of these PSU losses is the undercompensated requirements that government imposes on the companies to conduct noncommercial activities. These noncommercial obligations assume a range of types, as described in **Box 4**. The Government of Tamil Nadu pays subsidies toward the cost of these activities, and it provides guarantees, loans, and other fiscal support. However, the substantial and chronic PSU losses and the negative net worth of these PSUs illustrate that a significant part of the cost of PSU noncommercial obligations is not being borne by the State budget. For instance, the Passenger Transport Group had negative net worth of INR 90.47 billion in 2013–14 and INR 164.79 billion in 2016–17.

Box 4. PSU Noncommercial Activities in Tamil Nadu: Complex and Distortionary

Noncommercial obligations imposed on PSUs in Tamil Nadu include the following:

- **Requirements to sell services to consumers below the cost of supply**; for example, the electricity tariff has not been adjusted since 2014, and bus passenger tariffs lag behind costs. The government pays subsidies to compensate for lower prices for domestic electricity consumers, but the subsidies have not kept pace with the increasing gap between the cost of supply and regulated tariffs.
- **Requirements to provide services free of charge to specific consumers**; for example, electricity is supplied free to farmers and to some business consumers as part of an industrial development investment incentive scheme.

[22] Comptroller and Auditor General Report 2017–18, p. 74.

Box 4. PSU Noncommercial Activities in Tamil Nadu: Complex and Distortionary (concluded)

- **Cross-subsidies between different categories of customers**; for example, electricity is supplied at low cost to households and is financed by charging prices above cost to the business sector.

- **A cross-subsidy surcharge levied on businesses** that make use of the open access regulatory policy and purchase electricity from private suppliers.

- **The Government of Tamil Nadu's use of a PSU to conduct off-budget borrowin**g; for example, in the past a PSU borrowed funds for the implementation of government programs conducted outside of the State budget, and the loans have since been repaid from funds specifically provided by the government to the PSU.[23] Although this was revenue neutral for the PSU, it may have diverted the attention and efforts of PSU management from core commercial activities. Past and future off-budget borrowings would need to be included/ considered as part of the fiscal risks of the State, emanating from PSUs.

- **Arrears of payments by some government departments** of their electricity bills to TANGEDCO.

- **Unintended impacts of subsidized and free public services that could increase fiscal costs in other policy domains**; for example, free electricity for farmers could result in the inefficient use of pumps and the overconsumption of water, exacerbating Tamil Nadu's fresh-water stress (see the discussion of fiscal risks from natural disasters in **IIC**).

Source: Mission.

47. A fundamental driver of the cost of PSU noncommercial obligations is the failure to regularly adjust tariffs, particularly in the electricity sector. The Tamil Nadu Electricity Regulatory Commission (TNERC) determines tariffs for generation, supply, transmission, and distribution of electricity in terms of S.86 of the Electricity Act of 2003. The tariff policy applies to the level of distribution charges and surcharges under the open access policy that allows private companies to purchase electricity from private suppliers. TANGEDCO has not filed for a tariff increase since 2012, although TNERC granted a tariff increase in 2014 in the absence of a filing. In the absence of a tariff increase since 2014, electricity prices have declined in real terms, and the gap between TANGEDCO's costs and revenues has increased.

48. The effects of PSU noncommercial obligations are complex and have considerably weakened the financial position and service delivery performance of the companies. They also create the potential need for a cycle of periodic large injections of fiscal support to keep the companies operating—with major impacts on the State budget and level of public debt. The cross-subsidy between business and household users of electricity reduces the competitiveness of the private sector, harming economic growth, tax revenue growth, and the development of Tamil Nadu.

[23] Comptroller and Auditor General Report No. 1 of 2019, p. 32, which notes that these off-budget borrowings are not permissible under Article 293(3) of the Constitution of India.

It may also lead to pressure for other potentially distortionary policies to compensate businesses, such as tax incentive schemes for new investment.[24] Ultimately, these policies may be unsustainable.

49. Business customers are already switching to private electricity suppliers, despite the existence of a cross-subsidy surcharge, so that the tax base from which to subsidize households may erode further or even collapse at some point under pressure from the private sector.[25] To the extent that the PSUs find it difficult to finance new investment, public perception of chronic poor service quality may entrench consumer resistance to paying for the services—a vicious downward spiral.[26]

50. PSUs are overseen by Boards of Directors, officials from the relevant line department, and the FD. Officials from line departments and from FD sit on PSU Boards, and this practice is viewed as an important means of overseeing the operations of PSUs. PSUs are also required to seek approval from the relevant line department and FD for capital expenditures above INR 100 million and for land acquisition. The Bureau of Public Enterprises (BPE) in FD also monitors the performance of PSUs. It would be desirable to review the respective responsibilities of the line department and the different units in FD in monitoring PSU performance and overseeing the fiscal risks to government. The BPE—a separate unit reporting to the PS—publishes an Annual Report on the financial results of PSUs, but its oversight is backward looking and passive. It usually publishes the Annual Report, which is submitted to the legislature for information about 15 months after the end of the financial year.[27] The report contains details of the balance sheet and profit and loss performance for each PSU and Statutory Board. An overview section presents summary results across different portfolios of PSUs, but it does not contain any forward-looking information, any assessment of areas of strong or weak performance, or any discussion of the government's plans to improve performance. Nor does the BPE report internally to government on these issues.

51. The absence of information available on the costs of noncommercial activities undertaken by PSUs limits the ability to assess if they are meeting public policy objectives. No quantitative information is published on the cost of these noncommercial activities in the annual budget documents, and no information is included in PSU Annual Reports or in the Policy Notes

[24] There is, for instance, an electricity tax exemption allowed to some consumers in new Industrial Units and Special Economic Zones.

[25] TANGEDCO has a monopoly on distribution, but there are alternative suppliers that corporate customers can access through Open Access provisions. Around 40 percent of eligible customers have already opted for alternative suppliers.

[26] The CAG noted in a performance audit of TANGEDCO instances of costly failure to perform mandatory maintenance. Report of the CAG on Public Sector Undertakings for the year ending March 31, 2017, p. 23.

[27] Review of the Performance of State PSUs for the year 2016–17, which is the most recent published report.

produced by departments.[28] It is unclear whether the PSU or the government produces any additional information on the financial impacts on PSUs of their noncommercial activities.

Challenges

52. The challenge is to turn around the performance of the key loss-making PSUs while meeting social policy objectives more effectively.

53. A first component of this challenge is for TANGEDCO and the Passenger Transport Group to produce three-year forecasts of their financial performance and position under current policies. Doing this could mean extending the current exercise for compiling their budgets for 2020/21 by requiring them to add two additional years to their forecast, covering all of their operating and capital expenditures. The medium-term budget cannot be done simply on the basis of incremental budgeting. It requires a careful analysis of recent trends in costs and revenues and how these may evolve over the next three years; it also requires the development a view on likely macroeconomic developments in Tamil Nadu, examination of the timing of capital expenditures, and identification and assessment of specific risk factors. The chief executives of these companies could be instructed to prepare three-year forecasts for discussion and consideration by their boards, for subsequent transmittal to the relevant line departments and FD for review and discussion.

54. A second challenge is to ensure that the PSUs file for tariff increases in a timely manner. TANGEDCO, in particular, should file for tariff increases as soon as practicable with TNERC; the Passenger Transport PSUs should also submit regular and timely tariff filings.

55. A third challenge is to estimate the financial impacts on each of these PSUs of the noncommercial obligations and to identify beneficiaries from subsidized public services. The required information to generate the estimated financial impacts will be within the detailed accounts of the PSUs. These estimates will require careful work by a small team of professionals with full access to the detailed accounting and other records of the PSUs and to PSU staff and management. These advisers would be contracted by the Government of Tamil Nadu and would work for the government on a fully confidential basis. Estimating the cost of noncommercial activities conducted by public corporations can be complex and is discussed further in **Annex IV**. A serious effort should be made, by using PSU administrative data and any other relevant information to identify which social groups benefit from the subsidized or free services.

56. The fourth challenge is to use forecasts, together with the estimated cost of supplying noncommercial activities and information on beneficiaries, to generate broad options for improving the performance of PSUs. This process could involve the use of targeted subsidies

[28] For instance, the Policy Note 2019–20 of the Energy Department, while providing a table of tariff subsidies to TANGEDCO from Tamil Nadu since 2011–12 and a breakdown of subsidies in the current year's budget, does not refer to noncommercial obligations imposed on PSUs in the sector or to the undercompensation for their costs.

based on a means test or other specific government policies or mechanisms, rather than a blanket subsidy for all consumers or all consumers within a broad qualifying population.

57. The fifth challenge is the need to phase in reforms to PSU tariffs in combination with the implementation of targeted mechanisms to compensate the poor. Doing this means finding space within the government's annual budget to progressively increase the annual subsidies paid to TANGEDCO and the Passenger Transport Group to bring them closer to full compensation for the financial impact of these activities.

58. Finally, oversight of PSUs by FD needs to be extended to forward-looking monitoring and analysis. To be an effective advisor to the government on whether PSUs are operating effectively and efficiently and on fiscal risks to the government's budget, the FD and line department need to be forward-looking and proactive. Doing this will require the introduction of new requirements for PSUs to seek prior approval of their investment plans, as well as of large individual investments, and to report in-year (for example, quarterly) to FD and the line department. It will also require significant capacity building over the medium term in the BPE. **Annex V** contains further discussion of this PSU oversight role.

Recommendations

a. Short Term

- FD should require TANGEDCO and the Transport Passenger Group to prepare three-year financial forecasts and estimates of costs their noncommercial obligations.
- FD should seek a government decision to instruct TANGEDCO to file for a tariff increase as soon as practicable.
- FD should appoint external professional advisers to analyze the accounts of TANGEDCO and the Transport Passenger Group, identify beneficiaries of subsidized prices, and report options for turning around the companies' finances.

b. Medium Term

- FD should seek to progressively include in the budget the full costs of meeting noncommercial obligations in the energy and transport sectors.
- FD should progressively build its capacity to provide forward-looking, proactive oversight of energy and transport sector PSUs.

C. Revenue Risks

Current Situation

59. Revenue performance has lagged behind expenditure growth, and tax buoyancy is low, pointing to a structural problem. The revenue deficit increased from INR 18 billion in 2013–14

(0.18 per cent of GSDP) INR 216 billion (1.51 per cent of GSDP) in 2017-18.[29] Revenue expenditure grew 2.22 times faster than revenue receipts in 2017-18, while total revenue receipts grew by only 4.3 percent, considerably less than the growth rate of revenue receipts in comparable States in India.' The State's own tax buoyancy with respect to GSDP has ranged from 0.26 to 0.84 over the past five years and stood at 0.74 in 2017–18.

60. Receipts from one of the main revenue sources—taxes on alcohol—are expected to continue to decline. Taxes on alcohol comprise sales taxes and excise taxes; in 2017–18, they comprised 28 percent of the SOTR, which in Tamil Nadu made up 89 percent of the State's total revenues in 2017–18, higher than for most States. There is some risk around the future path of these revenues.[30] In addition, the compensation from GOI for GST revenue shortfalls is expected to end by 2021–22.

61. There may be opportunities to increase revenue collections by improving performance on revenue arrears and by reviewing tax exemptions. Revenue arrears as of March 31, 2018, were INR 301 billion, equivalent to 32 percent of SOTR and 75 percent of the fiscal deficit. Of this amount, 53 percent was under recovery process, 33 percent was under litigation, and action was yet to be initiated on the remaining 14 percent.[31] There may be opportunities to increase the rate and speed of collections and to reduce the flows of new arrears. There are also a number of tax exemptions under the jurisdiction of the Tamil Nadu government. The actual cost of the exemptions that are quantified was reported as INR 200 million in 2017-18, which is less than 1 percent of the fiscal deficit.[32] However, other unquantified exemptions may be more significant.

62. The rate of return on government financial assets is low. The average rate of return on government financial assets increased from 0.2 percent in 2013–14 to 0.62 percent in 2016–17, before declining to 0.45 percent in 2017–18.[33] This amount represents a fraction of the government's average rate of borrowing of 8.53 percent in 2017–18. The low return on investment was mainly due to the poor financial results of PSUs—although, as **Figure 10** shows**,** some PSUs are profit making and may present an opportunity for divestment, for example, Tamil Nadu News Print and Paper Ltd, which is a listed company. Another important cause of the low returns is poor management of government loans; for example, the poor record keeping of government loans to various borrowers,

[29] The data in this paragraph are from the State Finance Audit Report of the CAG for the year ending March 2018, Government of Tamil Nadu Report No. 1 of 2019.

[30] As noted in Section **I.A**, the Government has ordered the closing of 500 shops of the local State alcohol monopoly and restricted opening hours to reduce alcohol consumption.

[31] State Finance Audit Report of the CAG for the year ending March 2018, Government of Tamil Nadu Report No. 1 of 2019, p. viii.

[32] Statement of Tax Exemption/Reduction on Major State Taxes for the Financial Years 2017–18 and 2018–19. The largest exemption was for Stamps and Registration Fees (86 percent of the total). Tax exemptions were also reported in the Budget Memorandum Part-I, page 78, as amounting to INR 2.012 billion.

[33]Accounting for the financial bailout of the electricity PSUs in 2016–17 as loans rather than grants (prescribed by the Union government) had the effect of further lowering the return on assets.

including TANGEDCO contributed to write-downs in the value of loans or government grants to reduce the value of loans.[34] Finally, the CAG noted that the State invests the employee and employer contributions to the defined contribution pension scheme for civil servants in 90 day T-Bills, which earned interest ranging from 6.03 percent to 7.85 percent between 2015–2018; the interest paid to individual pension account holders ranged from 7.60 percent to 8.70 percent in this same period. The CAG observed that by not joining the Government of India's National Pension Scheme, the Government of Tamil Nadu incurred an avoidable additional expenditure on pensions for 2015–18 of INR 7.97 billion due to low returns on T-Bills.[35]

Challenges

63. Given the structural issues facing the revenue performance of the Government of Tamil Nadu, there is a pressing need for a medium-term revenue strategy. The practice in recent years of nominal tax or rates that have not been adjusted for some time to increase revenues is neither sufficient nor sustainable. The secular weak trend in revenues, combined with a limited space within the fiscal rules and a tightening fiscal outlook, points to the need for a more fundamental approach to assess whether there are feasible underexploited or untapped revenue sources. This approach requires a medium-term perspective rather than a series of more limited annual exercises, underpinned by adequate revenue forecasting capabilities developed as part of an overall macrofiscal function (see **I.A**).

Recommendation

a. Short Term

- Request IMF support to develop and implement a medium-term revenue strategy.

D. Other Specific Fiscal Risks

Current Situation

64. Tamil Nadu is exposed to a range of other specific fiscal risks, including debt management, expenditure arrears, contingent liabilities, legal claims, PPPs, disasters, and climate change. Each of these risks has the potential to impact significantly on the public finances and is discussed in turn.

[34] The write-off amount is Rs.2.5 billion as per government order G.O, Ms.No.68, Fin. [L&A] Dept., dated 23.2.2019.

[35] State Finance Audit Report of the Comptroller and Auditor General of India for the year ending March 2018, Government of Tamil Nadu Repot No. 1 of 2019, p. 19.

65. Risks in debt management include rollover risk[36], indirect exchange rate risk, and operational risks. During the four-year period from 2021–22 to 2024–25, 31.81 percent of the current outstanding debt—totaling INR 918.5 billion—will become due for repayment.[37] This amount represents a substantial fiscal burden and funding risk. The exchange rate risk is indirect through GOI borrowing internationally and on-lending to the Government of Tamil Nadu, although the level of foreign exchange exposure may be small.

66. Public debt is managed by staff in FD who are also responsible for other functions. Market operations are conducted by the Reserve Bank of India on behalf of the Government of Tamil Nadu, while the CAG performs record keeping for debt. Debt management operates in the absence of a medium-term debt management strategy and of a formal debt sustainability analysis.[38] A Consolidated Sinking Fund (CSF) for debt amortization, established in 2006–07, has a required annual contribution of 0.5 percent of the outstanding liabilities at the end of the previous financial year. The CSF balance as of March 31, 2018, was INR 58.66 billion—approximately 2 percent of total debt—invested mainly in GOI securities.

67. There are systematic expenditure arrears and an established practice of shortfalls in the government's annual contributions to various reserve funds. The government's financial statements do not present arrears as a liability, but it is understood that there are systematic expenditure arrears to external entities. In addition, the CAG notes that there are shortfalls in required contributions to Public Account Funds (for example, the Debt Sinking Fund, Pension Scheme Fund, and Guarantee Redemption Fund). Expenditure arrears create a control risk and, if not recorded as they arise, can accumulate unexpectedly and increase cost. They are liabilities of government (not contingent liabilities) and should be systematically recorded. The shortfalls in contributions to reserve funds also reflect that the desired level of provisioning is not being achieved due to fiscal pressures.

68. The management of risks from government guarantees exhibits a number of good practices, although exposures increased by 52 percent in 2018–19. These good practices include the following**:** (1) Guarantee fees are charged, and there is provision for them to be risk-based within a band; (2) a Guarantee Redemption Fund (GRF) was established in 2003; and (3) the TNFRA 2003 (as amended) caps outstanding risk-weighted guarantees at 75 percent of revenue receipts of the previous year or 7.5 per cent of GSDP, whichever is lower. These are all elements of good international practice. In practice, however, guarantee fees are set at a flat rate, and the fees are not always paid. Although there had been a declining trend of guarantee exposures between 2013–14 and 2017–18, and few guarantees have been called in the past 20 years, guarantees jumped by 52

[36] Rollover risk occurs when a debt cannot be refinanced at the same, or more favorable, terms.

[37] Data are as of March 31, 2018. Source: State Finance Audit Report of the CAG for the year ending March 2018, Government of Tamil Nadu Repot No. 1 of 2019, pp. 33–34.

[38] Although the FD does have a basic model for analysing debt sustainability.

percent in 2018–19 due to new guarantees issued to TANGEDCO. The balance of the GRF was only 0.7 percent of total guarantees outstanding as of March 31, 2018.

Table 4. Guarantees and the Guarantee Redemption Fund 2018–19

	2018/19, **INR billion**
Total Outstanding Guarantees as of March 31, 2018	361.3
As a share of revenue receipts	24.7%
As a share of GSDP	2.5%
Ratio of GRF to outstanding guarantees	0.7%
New Guarantees issued in 2018–19	188.2
Share of new guarantees to existing stock	52.0%
Share of new guarantees issued to TANGEDCO	97.0%

Sources: IMF Staff calculations drawn from the Appendices to the Budget Memorandum; Appendix-IV Statement of Guarantees given by the Government of Tamil Nadu; and Outstanding Guarantees as of March 31, 2018.

69. Other explicit contingent liabilities include legal action against the State government. The State is a respondent party to a range of legal claims, including claims against tax and duty assessments. At times, court decisions have had sizeable fiscal impacts, for example, with respect to taxes on alcohol. Departments are not required to record the existence or details of claims; no data are available on the stock of claims, the amounts claimed, or the stage at which the legal proceedings are. It is understood that the FD centrally monitors all of the significant legal claims to which FD itself is a respondent. Legal claims are explicit contingent liabilities similar to guarantees, and good practice is to maintain formal records at the departmental level and to aggregate the information for centralized oversight.[39] The State also initiates legal claims, particularly with respect to taxation (the Commercial Tax Department); these claims are in the nature of contingent assets.

70. A small number of PPPs is under implementation, but the government intends to significantly expand the number of PPPs. Existing projects include five road and water supply projects, partly financed through viability gap funding from the State budget. Available data are sketchy, but total annual payment commitments for two of the projects amount to INR 2.93 billion for up to 25 years. The government established the Tamil Nadu Infrastructure Development Board (TNIDB) through the Tamil Nadu Infrastructure Development Act 2012. TNIDB is chaired by the Chief Minister; the Minister of Finance is the Vice-Chair. The TNIDB's roles include developing and prioritizing public infrastructure through all modalities, conducting appraisals of all major public investment projects, evaluating proposed PPPs against a public sector comparator project, and recommending financial support for projects from the Government under the Tamil Nadu

[39] Outside of the government sector, TANGEDCO maintains internal records in a template of important sensitive cases with the regulator. However, it does not provide any indication of potential exposure, such as amounts at risk.

Infrastructure Development Fund or from the Central Government. Although the TNIDB has a pipeline of 169 PPP projects, the status and stage of each remain unclear.

71. **It is important that the Ministry of Finance has a formal budget gatekeeper role at the project appraisal stage**. This role is intended to advise the government on the affordability of each individual project and of the accumulated obligations and risks in the portfolio of approved and proposed projects. Because of the long-term debt-like obligations in some PPPs, as well as contingent liabilities, the government will need to maintain a complete central register of all projects and to ensure that the fiscal commitments in approved projects are incorporated in fiscal policy analysis. The IMF and the World Bank have developed the PPP Fiscal Risk Assessment Model (PFRAM) for this purpose.[40]

72. **Disasters are a significant source of fiscal risks.** Over the past 10 years, Tamil Nadu has experienced substantial fiscal costs from cyclones, floods, and droughts. Annual expenditure incurred on natural calamities since 2010–/11 ranged from a low of INR 3.75 billion in 2014/15 to INR 29.84 billion in 2015–/16. These costs are shared between the State Disaster Relief Fund and the GOI National Disaster Relief Fund; the National Fund pays 75 percent of the costs. Fiscal impacts include the provision of disaster relief to victims; expenditure on water shortage emergencies; reconstruction of damaged infrastructure; the need for new capital investment to increase the resilience of public infrastructure (for example, a cyclone-resilient electrical network project); and other investments in coastal disaster risk reduction.

73. **Tamil Nadu may be exposed to a range of fiscal impacts from climate change.** Climate change is associated with an increased likelihood of the incidence and severity of natural disasters, such as cyclones. Annual expenditures on calamities vary from year to year in Tamil Nadu, but the three most costly years over the past decade occurred in the past four years, indicating a potential increasing exposure.[41] Cyclone Gaja in November 2018 damaged the electricity network to a much greater extent than previous cyclones; total damages are estimated at INR 23.8 billion.[42] In addition to reconstruction, other climate-related spending pressures include the need for the increased investment in renewable energy sources and public infrastructure resilience.[43] Tamil Nadu may also be exposed to slow-onset disasters, such as water scarcity. Fiscal exposures resulting from this situation include spending on emergency drinking water deliveries and the current planning for three significant water desalination plants as PPP projects. It is important that FD takes a broad view of the

[40] PFRAM is an analytical tool to assess the potential fiscal costs and risks arising from PPP projects. Recognizing that PPPs might have significant macrofiscal implications, the PFRAM tool has been developed to quantify the macrofiscal implications of individual PPP projects. More information about PFRAM is available at https://www.imf.org/external/np/fad/publicinvestment/index.htm.

[41] Source: Table providing contingency amounts budgeted and actually spent from the SDRF/NDRF for 2010–/11 to 2018–/19.

[42] Energy Policy Note, p. 9.

[43] For example, the Cyclone Resilient Electrical Network under the Coastal Disaster Risk Reduction Project.

potential shocks to the public finances from climate change, considering a range of sources.[44] FD also needs to be alert to the possibility that some fiscal policies may be raising the level of environmental risks, such as the possibility that free or subsidized electricity result in the unnecessary and inefficient usage of scarce fresh-water resources.

74. Although the risks from local governments have not been apparent, the FD should monitor their finances. Fiscal shocks to higher levels of government from lower levels of governments are a common source of fiscal risk globally. Local governments are required to obtain State government approval before borrowing; however, it is still important for the FD to routinely monitor the evolution of local government deficits, expenditure arrears, and their risk exposures as an early warning of potential problems that could rebound on the state.

Challenges

75. Oversight of fiscal risks is currently only one year ahead, at best. Government revenues are projected at an aggregate level over the medium term, but bottom-up forecasts of government revenues are currently produced only for the next budget year. On paper, there are three-year expenditure forecasts; in practice, however, these have little credibility and are not relevant to fiscal management. Debt management operates in the absence of a medium-term debt management strategy or the ability to conduct formal debt sustainability analysis. The focus of spending on civil service pensions is one year ahead, and there is no actuarial calculation of the government’s pension liability. Even large PSUs only produce one year ahead financial forecasts, while, as discussed in **II.D**, the oversight of PSUs is largely backward-looking and passive. Accordingly, there is no medium-term orientation to fiscal policy or to the identification of fiscal risks.

76. Fiscal risk identification and monitoring should be extended to other important sources. Information is not recorded or aggregated on expenditure arrears (liabilities) or on legal action against the State (contingent liabilities), although a PPP register and pipeline are being populated.

77. The FD needs to progressively move to proactive and forward-looking management of fiscal risks from the current generally passive and reactive approach. Improved awareness of the need for fiscal risk management and of the capacity for it in FD is needed. The new IFHRMS piloted in January 2020 has the potential to help improve record keeping in FD, reduce operational risks (for example, in loans management), and improve forecasting capacity (for example, of multiyear pension expenditures).

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[44] See, for instance, World Bank. 2014. *Climate Change Public Expenditure and Institutional Review Sourcebook*. Washington, DC: World Bank. https://www.greengrowthknowledge.org/sites/default/files/downloads/resource/World_Bank_CCPEIR_Sourcebook_0.pdf.

Recommendations

a. Short Term

- FD should conduct a debt sustainability analysis with external support.
- Ways and Means should develop a medium-term debt management strategy.
- FD should review the legal framework for PPPs to ensure an adequate formal budget gatekeeper role with respect to each proposed PPP project.
- FD should instruct all line departments to maintain registers of expenditure arrears and legal action against their departments and report the information to FD.

b. Medium Term

- FD should introduce system of monitoring finances of local governments.

E. Disclosing Fiscal Risks

Current Situation

78. Elements of good practice fiscal risk reporting exist in Tamil Nadu. Information on some sources of fiscal risk are transparently published within various government documents. For example, with respect to guarantees, information is published on the value of outstanding guarantees by sector, by entity, and by risk weighting. Details on mechanisms designed to manage guarantee risks, such as guarantee fees owed and received and available contingencies funds, are also disclosed. Similarly, extensive information on loans from the State government that are outstanding are disclosed by entity, rate of interest, concessional terms, and lists of loans issued to entities in arrears are identified.[45] With respect to PSUs and corporations, schedules of transfers between entities and the State are published. The financial situation of individual PSUs can be found in their respective annual financial reports and also in a consolidated report produced by the FD (BPE) that looks at the aggregate performance of the PSU sector. This report identifies loss-making entities in a table, although is produced with some time lag.[46]

79. However, reporting practices across sources of fiscal risks are uneven, with some risks yet to be fully identified, analyzed, and disclosed. Publicly available information does not exist or is limited for some sources of fiscal risks. For example, the Government of Tamil Nadu does not assess or publish the impact of macroeconomic risks. Similarly, potential obligations arising from contingent liabilities for legal claims or outstanding arrears are not disclosed. Limited disclosures exist around the performance of local governments; expenditure arrears; future pension obligations like pensions, debt repayments, or PPPs. Further, although disclosure of PSU performance is

[45] Government of Tamil Nadu Finance Accounts, Volume II, Additional Disclosures to Statement 18, p. 552.
[46] Review of Performance of State Public Sector Undertakings and Statutory Bodies for the year 2016/–17. Bureau of Public Enterprises, Finance Department, Undated. This is the most recent report available.

generally very good, elements are absent, including identifying, analyzing, and reporting on the financial impacts of noncommercial obligations.

80. Where elements of good practice disclosures do exist, there is limited analysis to help readers connect the dots. The good practice disclosures referred to are very detailed, normally in tabular form. These disclosures most often include quantification; however, there is limited analysis supporting the disclosure and no narrative or assessment of the risks. This is important as it helps the reader better understand each of these risks, alongside the likelihood of these risks occurring and actions to help mitigate their impact.

81. Moreover, given that fiscal risk reporting is fragmented, it is difficult, even for the government, to build a comprehensive picture of overall fiscal risks to government finances and their interconnectedness. As discussed, while fiscal risk reporting practices exists across a number of elements, reporting practices for some sources of fiscal risks is more limited. Where disclosures exist, they are dispersed across different reports, making it difficult to visualize the full extent of fiscal risk exposure. A summary report of fiscal risks could assist the State to better understand and manage vulnerabilities by providing a sense of the totality of potential threats to the fiscal position; a summary could also, over time, help to inform an integrated understanding of the conditions under which they are likely to materialize, including an understanding of the interconnectedness among different risks types. This summary is important because IMF research has proven that fiscal risks are highly correlated.[47]

82. Fiscal risk reporting in Tamil Nadu primarily focuses on historical outcomes and has yet to inform future decision-making. Current disclosures, even in the budget documents, are largely historical, or at most are one year ahead. Disclosures do not generally feature any analysis of the nature of future risks, potential future impacts, likelihood of the risks materializing, and strategies to monitor and manage risks going forward. For example, while information currently disclosed in relation to PSUs is very detailed, identifying loss-making PSUs and the size of the loss, reporting, and analysis, the information is not yet forward-looking (see **II.A** for details).

Challenges

83. As fiscal constraints begin to bind, improvements in fiscal risk reporting are more important than ever to help manage the sustainability of State finances. Macroeconomic shocks are typically the most common and one of the largest sources of fiscal risk.[48] Sudden changes in fiscally relevant macroeconomic variables can result in sharp changes in government deficits and debts**.** FD and ministers have limited information on the potential impact that macroeconomic risks could have on the State's finances. The capacity to identify, analyze, and report on the impact of macroeconomic risks on the fiscal forecasts also appears limited (see **I.A** for details).

[47] IMF. 2016. "Analyzing and Managing Fiscal Risks—Best Practices." Report. IMF, Washington, DC.

[48] IMF. 2018. *Fiscal Transparency Handbook*. Washington, DC: IMF.

Box 5. Case Study: Reporting on Macroeconomic Risks in Brazil

In Brazil, the annual statement of fiscal risks provides some analysis of the sensitivity of revenues, expenditures, and debt to key macroeconomic indicators. Annex V of the Draft Budget Guidelines Law on fiscal risks devotes several paragraphs to macroeconomic risks.

It provides a series of sensitivity analyses (impact of a 1 percentage point change in GDP, inflation, the exchange rate, policy interest rate, and the wage bill) on total tax revenue and total social security revenue; and the impact of a 1 percentage change in the exchange rate, inflation rate, and policy interest rate on expenditure and debt.

Moreover, a new feature of the report, which was published in April 2016, is the presentation of an alternative macroeconomic scenario for 2016 and 2017, with consequences for the projections of selected revenues and expenditures. This analysis, however, does not cover all of the key variables of interest in assessing fiscal policy—notably, the budget balance and gross financing needs.

Source: IMF. 2018. *Fiscal Transparency Handbook*. Washington, DC: IMF.

84. **Without further efforts to identify, monitor, manage, and report on fiscal risks, the State will be left unprepared to deal with looming fiscal costs in the context of narrowing fiscal space**. As the State starts to reach the debt limits imposed by the fiscal rules against a potentially declining and narrow revenue base, the ability of the State to respond to fiscal risks as they emerge will become more challenging.

85. **A comprehensive approach to fiscal risk reporting is necessary to enhance the State's understanding, analysis, and management of risk exposures.** Comprehensive disclosure and analysis of fiscal risks can help to ensure that fiscal policy settings can respond to a range of potential future economic and fiscal shocks and that abrupt and disruptive changes in policy are avoided when risks materialize.

86. **Sound institutional arrangements are needed to support an effective and integrated approach to risk management.** Establishing a central function responsible for overseeing fiscal risk management **(Box 6)** is one way to help Achieve a comprehensive approach. The centralized function would facilitate coordination across the government and be responsible for putting together the overall picture on fiscal risk management. Individual departments and line ministries would be responsible and accountable for identifying, estimating, analyzing, and monitoring specific fiscal risks that fall within their functions.

Box 6. Options for a Fiscal Risk Function

Even where risks are recorded and managed at the ministerial level, a strong case can be made for centralizing monitoring and management of overall fiscal risk in a single body (IMF 2008. "Fiscal Risk: Sources, Disclosure and Management". A. Cebotari et al **.** IMF Washington DC

Centralization allows for an assessment of aggregate risk exposures across the government and for the identification of any systematic relationships and interactions among risks. It also facilitates examination as to whether risks emanating from various sources are offsetting (and therefore may not require mitigation).

This role can be assigned to a specific unit with a mandate to monitor how risks are evolving; establish risk-warning indicators; and undertake war-gaming exercises to respond to risks. The unit could be tasked with assessing whether risk mitigation practices are adequate and recommend actions to strengthen them where required. Over time, a high-level oversight committee could be established within FD to regularly discuss risks to the fiscal outlook during preparation of the budget.

Source:. 2016. "Analyzing and Managing Fiscal Risks—Best Practices." Report, IMF, Washington, DC.

87. Opportunities exist to leverage, build, and improve on fiscal risk disclosure practices in Tamil Nadu, bringing together an integrated and comprehensive picture of fiscal risks. Further efforts to strength fiscal risk reporting practices will be needed if the State is to continue to maintain its attractiveness to investors and keep pace with fiscal risk reporting reforms commencing in other parts of the country. Some Indian States, like Odisha, are already working to strengthen and modernize their fiscal risk reporting practices. Odisha has recognized the value of taking an integrated, comprehensive, and forward-looking approach to fiscal risk reporting following a recent IMF Technical Assistance mission.

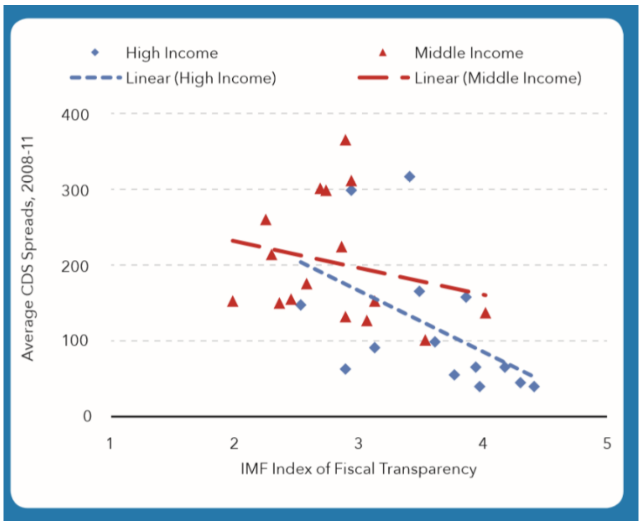
88. Publishing summary information on fiscal risks reinforces the credibility of the government's forecasts among creditors and across markets and, in some cases, can reduce borrowing costs. It enables decision-makers, the public, and the legislature to have a better grasp of risks and their potential impacts on the budget **(Box 7).**

Box 7. Why Is Fiscal Risk Disclosure Important?

Disclosing fiscal risks is a critical part of fiscal transparency. The IMF Fiscal Transparency Code,[49] the most widely recognized international standard for disclosure of information about public finances, devotes one-third of its principles to fiscal risk analysis and management. The Code requires that risks to the public finances be disclosed, analyzed, and managed and that fiscal decision-making across the public sector be effectively coordinated.

To enhance the credibility of its fiscal policy and forecasts, the Government of Tamil Nadu should provide summary information on fiscal risks to the public. When information is highly fragmented and dispersed across different reports, or when it is lacking, it becomes difficult to visualize the full extent of exposure to fiscal risks. It helps to boost support for mitigation policies, and it reinforces the credibility of the government's macrofiscal forecasts among creditors and across markets.

Figure 7.1. Fiscal Transparency and Market Perceptions of Solvency



Fiscal transparency is essential to effective fiscal management and accountability. It fosters good governance and helps to reduce corruption. It ensures:

- Governments have an accurate picture of their fiscal position and prospects and the costs and benefits of any policy changes to support a better-informed debate about the design and results of fiscal policy.
- Policymakers have a sound understanding of the potential risks to public finances and can better manage these, allowing for earlier and smoother fiscal policy adjustments where required.
- Legislatures, citizens, and markets have the information they need to hold governments accountable.

Greater fiscal transparency can also help strengthen the credibility of a country's fiscal plans and can help foster market confidence and market perceptions of fiscal solvency (**Figure 7.1**). The loss of market confidence in governments with underestimated or hidden deficits in the wake of the global financial crisis underscored the importance of fiscal transparency to global financial and economic stability.

Source: IMF. 2018. *Fiscal Transparency Handbook*. Washington, DC: IMF.

89. **A forward-looking approach to fiscal risk reporting would allow for more informed decision-making, as internal risk reports could feed into the budget process and increase the preparedness of the State to respond to adverse shocks.** Improved disclosure not only helps investors and citizens; it can also help the State to better understand, monitor. and manage fiscal risks, as these actions are mutually reinforcing activities. At a minimum, the State could work to

[49] For more information on the IMF Fiscal Transparency Code, refer to Chapter 4 of IMF. 2018. *Fiscal Transparency Handbook*, available for download at www.elibrary.imf.org/fth.

improve the internal reporting of fiscal risks. Progressively comprehensive reporting on fiscal risks within government to ministers at the time of budget development should be a priority. **Annex VI** provides an example fiscal risk register template that could be a useful tool for furthering internal fiscal risk reporting and external disclosure practices. Efforts should be prioritized toward fiscal risks that have the potential to be significant or where current practices need additional attention. **Box 8** provides country examples of fiscal risk statements.

Box 8. What Is a Comprehensive Fiscal Risk Report?

Summary reporting of fiscal risks is important for a complete understanding of potential threats to a country's fiscal position and an integrated approach to managing these risks. It allows for an assessment of aggregate risk exposures across the government and for the identification of systematic relationships and interactions among risks. It can also promote a better understanding of the true state of the public finances, build support for prudent fiscal policies, lead to better risk mitigation, strengthen accountability for risk management, and facilitate better policy responses.

An increasing number of countries produce summary reports in the form of a fiscal risk statement as part of their budget documentation. Such a statement usually includes a discussion of past experience with the materialization of risks, forward-looking estimates for various types of risk, and a discussion of policies to mitigate and manage risks.

A comprehensive fiscal risk statement helps to identify possible gaps and to ensure full coverage of risks. Its content should reflect the key fiscal risks facing a country and their evolving circumstances. Several countries—including Australia, Brazil, Chile, Colombia, Georgia, Indonesia, Kenya, New Zealand, Pakistan, the Philippines, and South Africa—consolidate information on fiscal risks in a single published document.

Source: IMF. 2018. *Fiscal Transparency Handbook*. Washington, DC: IMF.

90. An increasing number of countries has opted for the publication of a summary chapter or standalone report on fiscal risks, supported in many cases by domestic legislation. In the South and Southeast Asia region, Pakistan, the Philippines, and Indonesia have been trailblazers in relation to the publication of comprehensive fiscal risk statements. In its first occurrence, a Fiscal Risk Statement for Tamil Nadu could contain a simple, qualitative assessment of the most prevalent risks (a fiscal risk register), and, as available, quantitative information. It should at first cover macroeconomic risks, as well as the most significant sources of specific fiscal risks. Over the years, as the fiscal risk register becomes more exhaustive and internal reporting processes are strengthened, the report could be extended to other types of fiscal risks, become more detailed and more quantitative, and comprise more complex analyses. Following the presentation of each type of risk, a short paragraph should help the reader to understand by explaining the nature of the risk, its key features, the likelihood of occurring risks, and any mitigation measures taken. As the practice evolves, the presentation of fiscal risks could become a standalone document, published alongside the budget document. **Annex VII** proposes an outline for the fiscal risk statement, which becomes more elaborate over the years.

91. Requirements to publish comprehensive fiscal risk statements are supported by evolving international standards, reinforced by domestic legislation. These standards include the Government Finance Statistics Manual 2014, the International Public Sector Accounting Standards, and the IMF's Fiscal Transparency Code 2014. In addition, an increasing trend is to support fiscal risk disclosure practices with amendments to domestic legislation. Hence, consideration could be given to strengthening fiscal risk reporting requirements by amending the Tamil Nadu Fiscal Responsibility Act.

Box 9. Example of Modernization of Accountability Frameworks

The extract below from the Australian Government's Charter of Budget Honesty demonstrates how domestic frameworks can be modified to support improved transparency and reporting of fiscal risk by mandating that a Statement of Risks be published as part of each budget update.

In Australia, the Charter of Budget Honesty Act 1998 requires that any issues that might influence the actual budget outcome in the future—but that are not included in the Budget or forward estimates years—be disclosed in a Statement of Risks in each economic and fiscal outlook report.

Source: Charter of Budget Honesty Act 1998, subsection 12(1).

Recommendations

a. Short Term

- FD should establish a central fiscal risk function within the Finance Department.
- FD should develop a comprehensive approach to fiscal risk reporting, including in-year reporting using a fiscal risk register as a starting point.

b. Medium Term

- The FD should publish a Fiscal Risk Statement with the Budget documents.
- The FD should introduce fiscal risk disclosure requirements into the Tamil Nadu Fiscal Responsibility Act 2003.

Annex I. Budget Challenge Function

a. Definition of the Budget Challenge Function[50]

The challenge function describes **how the finance ministry investigates and scrutinizes the policy and expenditure choices of other public entities**.

The Budget Challenge Function can be divided into two main categories:

- The ***compliance challenge function*** relates to the enforcement of public financial management (PFM) rules governing budget preparation, execution, accounting, and reporting. It relies on establishing and communicating clear regulations and flows of information, as well as fostering a compliance culture and ensuring credibility of enforcement mechanisms.

- The ***policy challenge function*** relates to the use of financial and nonfinancial information to assess spending and other policy decisions made by line departments—beyond immediate matters of expenditure compliance and control—with the aim of aligning these with wider government and/or sector objectives.

The distinction between the two types of challenge function is not always clear, and it is likely that a finance ministry will engage with line ministries on both types of challenge simultaneously (for example, checking both the compliance to financial rules and the policy relevance of a new spending request).

However, in many developing countries, the focus is more on the compliance challenge function; the finance ministry challenge function tends to look at detailed spending decisions and compliance with budgeting rules. In contrast, in more advanced and emerging countries, the challenge function usually puts a greater emphasis on the policy challenge dimension, starting with the high-level policy choices of spending agencies.

b. Exercise of the Budget Challenge Function

The budget challenge function is centered on the ***interactions that take place between the Finance Department and line departments***, notably, on the occasion of the budget formulation process.

It requires a ***range of capabilities***, which may differ between a compliance and a policy challenge when in pursuit of different expenditure management objectives. For example, access to and the

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[50] The elements in this annex are largely drawn from Sierd Hadley and Bryn Welham. 2016. "The Ministry of Finance 'Challenge Function': A Public Financial Management Introductory Guide." Overseas Development Institute, London November. This document is available at https://www.odi.org/publications/10621-pfm-public-financial-management-ministry-finance-challenge-function and contains interesting resources and case studies on the budget challenge function.

ability to analyze nonfinancial information are fundamental features of a policy-based challenge function, which may not always be true of a compliance challenge.

A brief checklist of questions[51] for the exercise of the Budget Challenge Function would include:

a) Standard analysis of expenditure patterns:

- Calculating real growth levels in resource allocations to assess whether they are in line with the cost of providing services

- Comparing original budgets to actual spending (for example, are some areas or types of spending consistently under- or over-budgeted?)

- Monitoring changes in spending in different sectors to calculate the evolution of spending shares

- Calculating the unit cost of outputs and how it changes over time

- Calculating the cost of providing services per beneficiary, how this cost changes over time, and how this change in cost over timeis affected going forward.

b) Elements more related to policy, especially when confronted with new spending requests:

- Is the policy consistent with government strategic plans, and to what extent is it a priority? Is the level of resources proposed commensurate with these priorities?

- What is the overall policy objective, and are there more cost-effective ways of delivering the same objective?

- Does spending set a new precedent or introduce a financial commitment that will be hard to reverse for political, technical, or legal reasons?

- Does the policy create any significant fiscal risks?

- Does the policy directly affect other aspects of the macroeconomic or policy environment, for example, tax base, inflation, growth, employment?

- Who stands to lose or benefit from the policy, and by how much?

- Does the agency have the capacity to deliver the policy change?

[51] Source: The Collaborative Africa Budget Reform Initiative (CABRI). 2006. "Bridging the Gap from Policies to Budget." Annual CABRI Seminar, Addis Ababa, Ethiopia, November 28–30.

- Is the policy or proposed expenditure consistent with the government's systems of central and local government fiscal relations?

c. Situation of the Budget Challenge Function in Tamil Nadu

The Budget Challenge Function in Tamil Nadu is largely in its infancy.

Elements of a Compliance Challenge Function exist. These elements are underpinned by a budget circular that asks line departments to provide a series of elements on expenditure drivers, notably, detailed notes on all new or existing schemes totaling more than INR 200 million.

However, the Policy Challenge Function is almost totally absent. The budget system is geared to control (for example, micro-control over line items), not policy. More specifically, the chart of accounts and other classification systems focuses on budget inputs rather than outputs; in doing so, it supports effective micro-budget controls but not necessarily policy analysis. There is little or no reporting on policy implementation. Nonfinancial performance data are scarce and are not used in the budget discussion; rather, they are produced by line departments for the purpose of documents (policy notes) that are disconnected from the budget formulation process (available in June/July) and are not used in the budget discussions.

The organization of the budget wing of the Finance Department provides in theory a suitable set-up for the development of sectoral policy challenge capabilities. Like many budget directorates, the budget wing of the Tamil Nadu is organized into cross-cutting units (in charge of coordinating various aspects of PFM processes, such as budget preparation or execution) and sectoral units. These sectoral units (so-called PCB units—"Program cum Budget" units) in charge of discussions with the line departments in a specific policy area may be the focus for development of customized budget challenge capabilities.

Isolated examples of successful exercise of the Budget Challenge Function have already occurred. The mission was advised that the FD played a key role in bringing forward reforms in the health sector. It supported the establishment of a Public Sector Unit called Tamil Nadu Medical Services Corporation (TNMSC) as a unique purchaser of all essential drugs and medicines in the State Government Medical Institutions. This intervention led to a streamlined procedure for procurement, storage, and distribution of these goods, while providing a buffer in case of a sudden spike in demand for medicines; TNMSC could use its working capital to pre-finance and procure medicines urgently needed without having to wait for budget appropriations to be made available to the Health and Family Welfare Department. The Finance Department was also instrumental in advocating the outsourcing of the maintenance and cleaning of government hospitals. This reform is understood to have achieved significant savings through the progressive reduction of the headcount of non-medical staff at public hospitals, while ensuring better quality of service through maintenance contracts that integrate a series of key performance indicators.

Annex II. Proposed Budget Calendar to Implement Top-Down Budgeting

Timeline	Finance Department	Line Departments
April–June	• Review macroeconomic and fiscal framework, analyze previous year's forecast deviations, and develop preliminary macroeconomic and fiscal forecasts. • Update medium-term fiscal framework. • Obtain general guidance from political leadership on broad policy priorities for the next budget. • Execute internal work to identify possible sources of savings per sector, and develop policy challenge capabilities.	• Review strategic priorities, and evaluate existing schemes • Identify and cost new schemes
July	• Develop spending ceilings based on preliminary macroeconomic and fiscal forecasts and assessment of fiscal risks. • Submit medium-term macrofiscal forecasts and annual spending ceilings for approval by Council of Ministers (or subcommittee) • Prepare draft fiscal strategy report (pre-budget statement) outlining forecasts, fiscal strategy, spending priorities, and aggregate expenditure for major sectors.	
Early August	• Issue budget circular, including annual sectoral spending ceilings, require information to be submitted by line departments including expenditure arrears, legal action • Provide detailed instructions on determining spending estimates within expenditure ceiling for each demand for grants. • Include all relevant deadlines, as well as key macrofiscal assumptions in budget circular. • Schedule training sessions for all departments to familiarize them with the requirements of the circular.	• Departments prepare their budget estimates, including new schemes, according to budget circular within ceilings. • Departments provide provisional estimates of Centrally Sponsored Schemes, based on the annual action plans submitted to Union government.

End September	• Review and update macrofiscal forecasts in line with latest assumptions. • Review Centrally Sponsored Schemes and trends, and prepare preliminary budget forecast based on the annual action plans submitted by departments to the Union government.	• Departments submit budget proposals to finance department.
October	• Hold Decentralized Budget Meetings (DCB Meetings) to discuss budget estimates.	
November	• Submit contentious issues (sustainability of expenditures within the ceilings) to the political leadership. • Submit fiscal strategy report to Cabinet for information in the short-term, and for approval and publication of the document(in the medium-term.	
December	• Prepare supplementary budget to adjust expenditure and revenue estimates, if required. • Request budget approval by the Council of Ministers	• Departments prepare revised estimates for supplementary budget, if required.
January	• Revise and finalize macrofiscal forecasts and fiscal framework, as required. • Make final adjustments to budget estimates, based on the result of budget negotiations. • Prepare budget documents.	• Departments provide input for the budget speech and other budget documents on new schemes and spending priorities.
February	• Confirm final estimates for Centrally Sponsored Schemes after Union budget is tabled. • Finalize budget speech. • Table budget in legislature for approval.	
March	• Receive approval of appropriation bill from legislature.	

Annex III. Proposed Outline for the Fiscal Strategy Report

The document should be a maximum of 30 pages and should contain tables and visual charts, as well as clear and easy-to-read narratives.

Executive summary

A concise summary of narrative explaining the macrofiscal environment and the Government of Tamil Nadu's key fiscal policy choices

I. Economic overview

A. Economic policy and development strategy

A brief section that summarizes the development and economic goals guiding the government's economic policy

B. *Recent economic performance*

Outturns for key macroeconomic aggregates (and breakdown by economic sector) over several years, including provisional outturns for the previous year, accompanied by a narrative on key macroeconomic and sectoral drivers, including information on the impact of global and domestic macroeconomic environments

C. State economic outlook

Forecasts for key macroeconomic aggregates (and breakdown by economic sector) over the current year, the budget year, and two forward years, accompanied by a narrative on key macroeconomic and sectoral drivers; should include forecasts made in the previous year's report and explain deviations.

II. Fiscal overview

A. Fiscal policy objectives and priorities

A brief section that summarizes the State's medium-term fiscal policy objectives, describes the fiscal responsibility framework set by the FRBM, and provides an overview of major recent fiscal policy decisions

B. Recent fiscal performance

Outturns for key fiscal aggregates (and breakdown by economic/administrative classification of revenue and expenditure) over several years, including outturns for the previous year (with explanation of deviation relative to BE for that year), accompanied by a narrative on key drivers.

C. State fiscal outlook and risks

Forecasts for key fiscal aggregates (and breakdown by economic/administrative classification of revenue and expenditure) over the current year, the budget year, and two forward years, accompanied by a narrative on key drivers and assumptions; forecasts should distinguish between the baseline and the fiscal space available for new measures; should include forecasts made in the previous year's report and explain deviations

D. Priorities for the upcoming budget year

Broad sectoral expenditure ceilings for the upcoming budget year, with a brief explanation of the key drivers and assumptions

III. Spending Priorities and Provisional Resource Allocation

A. Analysis of recent trends in public spending by function (sector) and economic item, as well as major policy trends and shifts

B. Identification of key expenditure policies to be addressed over the medium-term (for example, high levels of wage bill spending, crowding out of maintenance and service delivery, and improving access to drinking water)

C. Identification of key State government policies and priorities that will impact resource allocations among major schemes, funding requirements, and ways to fund new schemes within available fiscal space

D. Resource allocation implications covering both ongoing expenditure commitments and initiatives and new requirements linked to stated government policy priorities

E. Identification of schemes to increase spending, realize savings, or contain spending

F. Indicative resource ceilings for each major demand and major spending program (showing past allocations, a revised estimate for the current year, and projected allocations over the medium term)

IV. Fiscal risks

This section provides a qualitative and quantitative assessment of fiscal risks in Tamil Nadu (see Chapter II onward).

Annex IV. Monitoring of Public Corporations

Internationally, public corporations are a major source of fiscal risks to government finances. In a large cross-country survey of episodes in which specific fiscal risks materialized from 1990–2014, bailouts of public corporations were the second-largest category of fiscal risk after the financial sector (which includes many state-owned financial companies).[52] The cost of the bailouts was 3 percent of GDP on average and 15.1 percent of GDP in the most extreme case (in some cases, more than one large public corporation was rescued).

To mitigate fiscal risks from their public corporations, governments put in place oversight and control arrangements. The challenge is to avoid both passive oversight, on the one hand, and excessive government intervention in the operational autonomy of Boards and management, on the other hand.

Oversight arrangements vary considerably across countries—although, as a general principle, corporations that are performing poorly or that generate significant fiscal risks are subject to more intensive government oversight and monitoring. [53]

Financial control instruments generally include some combination of the following:

- the setting of financial objectives (for example, for dividend, profit, or return on equity)
- financial plan requirements (for example, description of investment plans, noncommercial activities, and financial and operational risk controls)
- borrowing and guarantees (some governments set ceilings on individual or total corporation borrowing, and some prohibit or control issuance of guarantees)
- restrictions on the sale or pledging of assets
- requirements for approval of mergers and acquisitions.

Box 1 describes arrangements for overseeing public corporations in South Africa.

[52] Bova, E., M. Ruiz-Arranz, F. Toscana, and H. Elif Ture. 2016. "The Fiscal Costs of Contingent Liabilities: A New Dataset." IMF Working Paper 16/14, International Monetary Fund, Washington.

[53] For information on arrangements in a wide range of countries, see OECD. 2018. *Ownership and Governance of State-Owned Enterprises: A Compendium of National Practices*. Paris: OECD.

Box 1. Monitoring of Public Corporations in South Africa[54]

The Public Finance Management Act of 1999 and Treasury regulations require public enterprises to submit the following on an annual basis: (1) strategic plans, (2) financial plans, and (3) risk management plans.

The Department of Public Enterprises (DPE) enters into a Shareholder Compact (a form of Performance Agreement) with six of the largest commercial state enterprises, in which key performance indicators and other performance data are formalized. The DPE is responsible for approving significant transactions into which the enterprise enters. The Minister of the DPE is also responsible for nominating the board members of most public enterprises, who must then be approved by the Cabinet.

Public enterprises are required to submit multiyear budgets to the DPE at least one month before the start of their financial year. The National Treasury imposes annual limits on the borrowing, guarantees, and other contingent liabilities of the enterprises.

The Fiscal Liability Committee in the National Treasury advises the Minister on short- and medium-term contingent liabilities and guarantees related to public enterprises.

Public enterprises are required to prepare annual financial statements in line with generally accepted accounting practices within five months of the end of each year. They are also required to submit quarterly financial reports to the DPE or the supervising ministry when they are not subject to DPE oversight.

Source: IMF staff, based on review of South Africa's SOEs.

[54] Source: Allen, R., and M. Alves. 2016. "How to Improve the Financial Oversight of Public Corporations." Note 5, IMF, Washington, DC. November 2016. https://www.imf.org/en/Publications/Fiscal-Affairs-Department-How-To-Notes/Issues/2016/12/31/How-to-Improve-the-Financial-Oversight-of-Public-Corporations-44373.

Annex V. Quantifying the Impacts of Noncommercial Activities Conducted by Public Corporations

As discussed in **II.A**, some public corporations in Tamil Nadu (PSUs) are required to deliver specified public services to certain consumers at prices below cost or free of charge. Some are also required to cross-subsidize between different categories of customers, charging some consumers above cost to finance the cost of supplying others below cost.

These are noncommercial activities that a private sector supplier would not undertake. They are also referred to as "quasi-fiscal activities" (QFAs)—government activities conducted off the government's budget by public corporations to further a public policy objective and that worsen the corporations' financial position relative to a strictly commercial profit-maximizing level.[55]

International good practice is for governments to fully compensate their public corporations for the cost of any noncommercial activities they undertake. Doing this requires a quantification of the financial impacts of such noncommercial obligations on the public corporation concerned, which can be challenging, and which may incorporate elements of supplier inefficiency.

The data required for quantification will often need to be acquired from the corporations involved. How difficult this is will depend, in part, on (1) whether the public corporation's accounts contain separate records of their commercial and noncommercial activities, and (2) the reliability of their accounting information.

Box 11 describes two general approaches to estimating the cost of noncommercial activities. These approaches rely on simplifying assumptions but are intended to illustrate the general approach.

[55] Also referred to as "Public Service Obligations."

Box 11. Examples of Quantifying the Financial Impact of Noncommercial Activities by PSUs[56]

Example A: Reduced rail tariff for students

The government requests that the Public Railway Corporation transport college students from the Central Station to the University Station at one-fourth of the regular fare ($1 per trip).
In 2015, the Railway Corporation sold 23,000 student fare tickets. Cost of 2015 quasi-fiscal activity = $17,250 = 23,000 × $0.75 (assumes a price elasticity equal to zero).[57]

Example B: Subsidized bus route to a rural community

The government requests that the Public Bus Corporation maintain in operation a loss-making route between the capital city and a rural community without raising fares charged to passengers. The government allowed the corporation to borrow in order to cover the underlying deficit, and it has agreed to pay compensation sufficient for the corporation to achieve a financial surplus on this route comparable to the surplus obtained on other routes it operates.

Details of the operations of the loss-making route in 2015 were as follows:
Operating costs, $56 million; interest paid, $4 million; ticket sales, $20 million.
The average surplus obtained on other routes was 10 percent of ticket sales.
Estimated economic cost of 2015 quasi-fiscal activity (millions) $56 + $4 – $20= $40 Compensation paid in 2015 (millions) $46 = ($56 + $4) × 1.1 - $20

Source: Adapted from IMF. 2016. "Analyzing and Managing Fiscal Risks: Best Practices." Report. IMF, Washington, DC.

[56] Source: R. Allen and M. Alves. 2016. "How to Improve the Financial Oversight of Public Corporations." IMF, Washington, DC. How-to Note 16/05. IMF, Washington, DC, November. https://www.imf.org/en/Publications/Fiscal-Affairs-Department-How-To-Notes/Issues/2016/12/31/How-to-Improve-the-Financial-Oversight-of-Public-Corporations-44373

[57] That is, demand does not change at all when price changes. This is an unrealistic assumption but is made to provide a first approximation. Alternative elasticities could be used, if possible, based on some empirical evidence.

Annex VI. Template of a Fiscal Risk Register

A fiscal risk register can be a tool for the FD to collect information on fiscal risks, to obtain an aggregate perspective on the fiscal risks to which the government is exposed, and to monitor the evolution of fiscal risks. A fiscal register can help to inform the internal reporting of fiscal risks and then form the basis for the development of an external Fiscal Risk Statement to be published alongside the budget papers.

The following template may help FD in developing such a register:

- **First, the sources of fiscal risks need to be identified**. Over time, the identification of risks can become more exhaustive and detailed (for example, they can not only capture government debt as a source of fiscal risk but also be more specific and differentiate foreign currency and interest rate risk).

- **Second, risk exposures need to be identified**. The exposure of some risks is easy to identify, for example, guaranteed debt outstanding for government guarantees. The exposure of other risks is more difficult, for example, natural disasters risk exposure, which could be virtually limitless. Proxies may be used for the latter risks. For example, maximum probable losses or the worst historic risk materializations (and the possible addition of a margin for even larger risk materializations in the future) may be used.

- **Next, the likelihood and severity of risk materialization need to be understood.** This may analytically be the most demanding step. Understanding the likelihood of risks materializing requires risk analysis. Methods used for risk analysis may differ by type of risk (for example, risk rating may be appropriate for analyzing the likelihood of financial distress of PSUs; for PPPs, risk modeling (such as of traffic revenues in the case of a road project where the government bears demand risk) may be more appropriate. This risk analysis should be forward-looking. Initially, an understanding of the historic realization of risks should be developed.

For important fiscal risks, risk mitigation measures should be developed to protect public finances.

FD will be responsible for managing various fiscal risks, but some fiscal risks may be managed outside of FD. It will be important to capture risk owners to facilitate the coordination of risk management efforts across the government.

Template: Fiscal Risk Register

Index	Source of fiscal risk	Estimated exposure	Description	Likelihood of materialization	Severity of risk materialization	Mitigation actions	Risk owner	Source of information
1	Revenue risks							
2	Expenditure risks							
3	Natural disasters							
4	Loans issued by the government							
5	Financial performance of PSUs							
6	Risks to the debt portfolio							
7	Outstanding payables (Arrears)							
8	Pension liabilities							
9	PPPs							
10	Government guarantees							
11	Legal claims							
12	Other contingent liabilities							
13	Other fiscal risks							

Source: Mission.

Annex VII. Phased Approach to the Development of a Comprehensive Fiscal Risk Statement

A basic level of practice is to list and discuss the main specific risks in qualitative terms, even if there is no estimation of their cost or likelihood that they will materialize. The value of such disclosures is that they raise awareness among policymakers and the public regarding the existence and nature of the risks concerned. All of the information on specific fiscal risks should be summarized in a single report, even if details are presented in a variety of other documents, such as reports on public debt, financial stability, the public corporation sector, and local government finances. In addition to disclosing the main risks to the public finances, good practice requires some quantification of risks. At a minimum, these estimates could include the maximum exposure associated with the liabilities concerned (which is already available for a number of components). Providing such data helps to inform the prioritization of actions to mitigate and manage risks. Collating the quantitative information into a single summary report also makes it possible to consider potential interactions among risks, as well as the government's combined gross exposure.

Component	Short Term	Medium Term	Longer Term
Introduction	Provide qualitative summary of the main fiscal risks facing Tamil Nadu.	Provide qualitative summary of the main fiscal risks facing Tamil Nadu: overview and presentation of the framework for identifying, analyzing, monitoring, and publishing risks in Tamil Nadu.	Publish an assessment of the linkage and correlations amongrisks.
Forecast performance	Anaylze the variance of revenue and expenditure BEs versus outturns in recent years.	Anaylze the variance of revenue and expenditure BEs versus outturns in recent years	Analyze the variance of revenue and expenditure BEs versus outturns in recent years
Macroeconomic risks*	Publish qualitative explanation of the sensitivity of revenues (including central transfers) and expenditures to variations in real state GSDP growth and inflation, with charts illustrating the volatility of these macroeconomic indicators.	Publish quantitative analysis of sensitivity of aggregate revenues (including central transfers) and expenditures to variations in real state GSDP growth and inflation, with explanation of underlying mechanisms.	Publish quantitative analysis of sensitivity of aggregate revenues (including central transfers) and expenditures to variations in real state GSDP growth and inflation, with explanation of underlying mechanisms. Include sensitivity analysis and alternative macroeconomic and fiscal forecast scenario.

Component	Short Term	Medium Term	Longer Term
Financial performance of PSUs*	Publish qualitative discussion of broad overview of risks weighing on the SOE portfolio macroeconomic shocks. Quantify quasi-fiscal activities, *etc*.	Publish quantitative discussion of broad overview of risks weighing on the SOE portfolio, including financial risk ratios for leverage and solvency. Include a discussion of the ownership policy for major PSUs.	Publish quantitative discussion of broad overview of risks weighing on the SOE portfolio, including financial risk ratios for leverage and solvency. Include a discussion of the ownership policy for major PSUs.
PPPs*	Publish a complete list of approved PPP projects and a qualitative discussion of the nature and objectives of the PPP contract. Publish aggregate annual service payments and receipts (including concessions) over the life of the PPP contracts.	Publish a description of government's PPP policy/strategy. Publish multiyear liabilities of the current PPP program. Explain if the gross exposure to guarantees and other possible contingent liabilities relating to PPP contracts.	Publish a description of government's PPP policy/strategy. Publish multiyear liabilities of the current PPP program.
Government guarantees*	Publish the rationale and criteria for the provision of major guarantees. Discuss risk mitigation.	Publish rationale and criteria for the provision of major guarantees. Discuss risk mitigation measures and factors underpinning the assignment of risk weighting.	Publish rationale and criteria for the provision of major guarantees. Discuss risk mitigation measures and factors underpinning assignment of risk weighting.
Loans issued by the Government	Publish qualitative disclosure associated with major loans, indicating their nature, policy purpose for the loan, and discussion of the risks associated with loan repayment or history of loan restructuring.	Publish qualitative disclosure associated with all loans above a certain threshold. Quantify the risks associated with loan repayment, even at the aggregate level.	Publish qualitative disclosure associated with all loans above a certain threshold. Quantify the risks associated with loan repayment, even at the aggregate level.
Pension liabilities	Publish a qualitative discussion of the two pensions schemes and the risks associated with them.	Publish a quantitative analysis of the expected future pension obligations on the budget.	Publish a quantitative analysis of the expected future pension obligations on the budget.

Component	Short Term	Medium Term	Longer Term
Legal claims	Publish a qualitative discussion of the major legal claims pending against the state, outlining the nature of the claim and, where feasible, estimates of gross exposure.	Publish a complete list of outstanding claims above a certain materiality threshold.	Publish a complete list of outstanding claims above a certain materiality threshold.
Natural disasters	Publish] qualitative analysis of the fiscal risks associated with natural disasters. Provide Hhistorical analysis of economic costs of past disasters, frequency, and associated fiscal costs for immediate relief and rehabilitation efforts.	Publish qualitative analysis of the fiscal risks associated with natural disasters. Provide Historical analysis of economic costs of past disasters, frequency, and associated fiscal costs for immediate relief and rehabilitation efforts. discussion of risk mitigation measures.	Publish] qualitative analysis of the fiscal risks associated with natural disasters. Provide Historical analysis of economic costs of past disasters, frequency and associated fiscal costs for immediate relief and rehabilitation efforts. discussion of risk mitigation measures.

Source: Mission.

Note: * Indicates areas of high priority/quick wins.

Example of Outline of a Comprehensive Statement of Fiscal Risks

Macroeconomic Risks: Comparison of recent macroeconomic assumptions included in the budget against outcomes; sensitivity of aggregate revenues, expenditures, budget balance, and debt to variations in key economic assumptions; alternative macrofiscal scenarios or probabilistic fan charts.

Public Debt: Sensitivity of the stock of debt and debt-servicing costs to variations in key parameters (for example, interest rates and exchange rates); discussion of debt management strategies; and summary results of debt-sustainability analysis.

Government Lending Programs: A policy framework for lending programs; the stock of outstanding loans in aggregate and by borrower or borrower category; the purpose of loans; and details of loan performance (including disclosure of nonperforming loans, outstanding amounts, or any history of loan restructuring).

Government Guarantees: The policy purpose of guarantees and any guarantee programs; intended beneficiaries; total guaranteed amounts (gross exposure); the likelihood that guarantees will be called (where appropriate and feasible) and the associated costs; the history of guarantee calls (that is, amount of government payments on servicing guaranteed loans); information on any recoveries; guarantee fees; and budget provisions.

Public-Private Partnerships (PPPs): Details of government obligations under PPPs, both direct commitments and any obligations related to contingent liabilities arising from the risks assumed by the government.

Public Corporations: Any explicit obligations to public corporations not disclosed elsewhere in the fiscal risk statement; the aggregate financial position of the sector; recent financial performance (including information on loss-making entities, and key financial risk indicators); transactions with the government; and quasi-fiscal activities.

Subnational Governments: A summary of the recent financial performance and position, financial exposures of local governments, and any explicit obligations of the central government to subnational governments not disclosed elsewhere.

Financial System: Any explicit liabilities to the financial sector not disclosed under guarantees; the size of the financial sector; an assessment of the soundness of the financial system and its regulation, drawing on a comprehensive, accurate, and systematic analysis of financial stability.

Natural Disasters: Discussion of the country's exposure to natural disasters; the direct fiscal impact of natural disasters in recent years; allowance for natural disaster-related costs in the budget; a summary of the government's disaster risk management strategy, including catastrophe risk insurance.

Legal Claims: Discussion of any legal claims pending against the state and, where feasible, estimates of gross exposure (such as plaintiff claims).

Other Material Fiscal Risks: Such as geopolitical or security risks where relevant; the gross exposure of indemnities, warranties, uncalled capital, or a summary of obligations where they cannot be quantified; other fiscal commitments not included in the fiscal forecasts because their timing or magnitude is uncertain; and risks to tax and nontax revenues, for example, from tax base erosion, avoidance, and evasion.

Source: IMF. 2018. *Fiscal Transparency Handbook*. Washington, DC: IMF.