

Kerala Development Society

Seminar on

“Kerala’s Development in a Globalized Scenario: Fiscal Issues”

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Financing Government Expenditure

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Fiscal Snapshot

Items	1999-2000 accounts	2000-01 accounts	2001-02 accounts	2002-03 accounts	2003-04 accounts	2004-05 Accounts	2005-06 prel. Accounts	06-07 BE
Revenue Receipts	7944	8731	9056	10638	11815	13500	15296	19140
State Tax Revenue	5194	5870	5923	7303	7843	8964	9779	11663
State Non-Tax Revenue	533	659	543	682	807	819	937	1113
Central Government Transfers	2218	2202	2590	2654	3165	3718	4581	6365
i. Share of Central Taxes	1535	1586	1614	1715	2258	2405	2518	3027
ii. Grant in aid	682	616	975	938	908	1313	2062	3338
Capital Receipts	4489	4115	3432	4703	5505	4680	4391	7516
a. Public Debt (Net)	1566	2091	1960	2593	4767	4038	4001	5679
b. Public Account (Net)	2871	1907	1473	2110	665	546	338	1744
Total Receipts (A+B)	12433	12845	12489	15341	17321	18180	19687	26656
Non Plan Expenditure	9513	10020	9908	11731	14308	14094	15237	21423
Plan Expenditure (including CSS)	2698	2706	2473	3974	3119	3953	4300	5345
Total Expenditure	12211	12726	12381	15705	17427	18048	19536	26768
Revenue Surplus/Deficit	-3619	-3147	-2606	-4118	-3680	-3669	-3136	-5415
Fiscal Deficit	-4215	-3878	-3325	-5067	-5539	-4452	-4189	-7534
Primary Deficit	-2263	-1620	-835	-2120	-2211	-839	-382	-3107
GSDP	62520	69770	72349	80844	90172	100327	111363	126174
RD as % of GSDP	-5.8%	-4.5%	-3.6%	-5.1%	-4.1%	-3.7%	-2.8%	-4.3%
FD as % of GSDP	-6.7%	-5.6%	-4.6%	-6.3%	-6.1%	-4.4%	-3.8%	-6.0%

Fiscal Snapshot

- Continuous improvement in fiscal parameters over the last three years.
- Burden of adjustment fell disproportionately on Capital and Plan expenditure.
- Fiscal position to deteriorate sharply in 2006-07 on account of Pay Revision of Public Sector employees.
- XII Finance Commission target of 0% RD and 3% FD unlikely to be attained by March 2008.
- Since capital expenditure is under 1% of GSDP it is revenue expenditure that needs to be targeted.

Fiscal Straitjacket 2005-06

- Government expenditure exceeds revenue receipts by 27%.
- 94% of Government expenditure is revenue expenditure
- 63% of government expenditure is on Salary, Pension and Interest payments.
- Salary, Pension and Interest are equivalent to 115% of State's Own Revenue and 80% of all revenue receipts.
- Salary and pension payments to rise sharply from 2006-07 on account of Pay Commission award.
- Over the years SPI has crowded out both State Plan Expenditure (currently 3.5% of GSDP) and Capital Expenditure (0.7% of GSDP).
- High and sustained fiscal deficits in the past have burdened the State with a big debt overhang

Movement of Public Finance Indicators

Indicator	88-89	89-90	98-99	99-00	05-06	06-07BE
RE/TE	88%	86%	90%	92%	94%	92%
SPI/TE	61%	73%	57%	66%	63%	61%
SPI/RR	74%	95%	81%	104%	80%	86%
SPI/SOR	97%	122%	112%	144%	116%	129%
Capex/TE	8.0%	9.2%	6.6%	5.3%	3.8%	4.2%
PE/TE			31%	25%	20%	24%
RR/GSDP	18%	17%	13%	13%	14%	15%
TE/GSDP	22%	22%	18%	20%	18%	21%
FD/RR	22%	30%	42%	57%	27%	39.4%
FD/GSDP	3.9%	5.0%	5.4%	7.3%	3.8%	6.0%
RD/RR	9%	12%	28%	46%	21%	28.3%
RD/GSDP	1.5%	2.0%	3.6%	5.8%	2.8%	4.3%
Debt/RR	177%	192%	218%	254%	298%	278%
Debt/GSDP	31%	32%	28%	32%	41%	42%

RE/TE : Revenue Expenditure/Total Expenditure

RD/FD: Revenue Deficit/Fiscal Deficit

GSDP : Gross State Domestic Product

PE : Plan Expenditure

RR : Revenue Receipts

SPI : Salary, Pension & Interest

SOR : State's Own Revenue

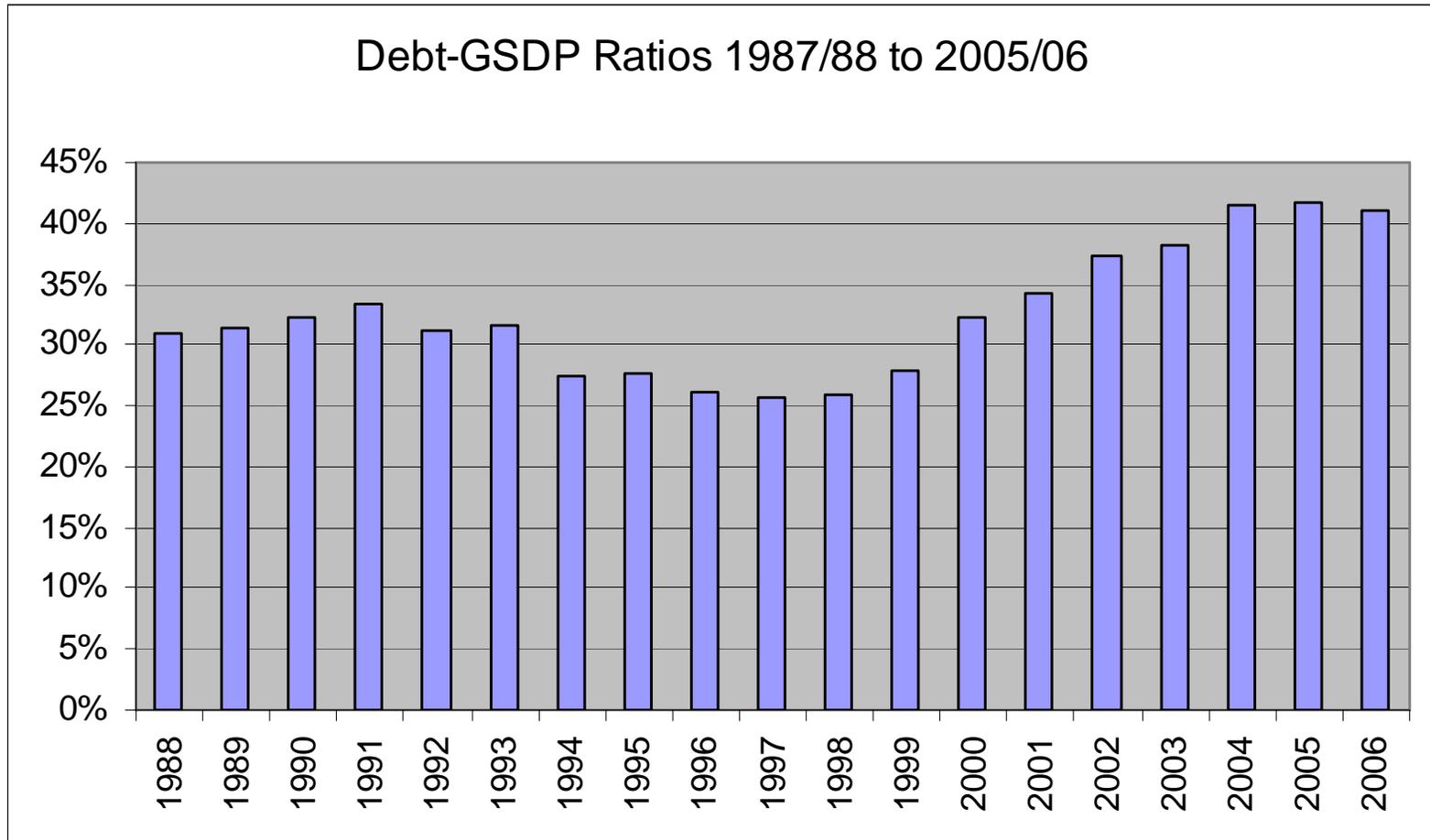
Capex : Capital Expenditure

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Budget Cycles

- Just like business cycles, there are pay-commission linked five yearly budget cycles
 - Government expenditure as a proportion of GSDP rises and tapers off thereafter.
 - Revenue Expenditure as proportion of total expenditure rises sharply and declines gradually thereafter
 - RD and FD deteriorate sharply and improve gradually thereafter
 - Critical balancing role of Public Account
 - Debt ratios worsen and stabilize thereafter at higher levels: ascending sine-curve.

Ascending Debt Sine Curve



Change in Kerala's (total) Debt Portfolio

Indicator	85-86	90-91	95-96	00-01	05-06
Debt (Rs. Cr)	2242	4965	10669	25717	48481
5 YMA Gr		17.2%	16.7%	19.7%	13.3%
Internal Debt	18%	24%	25%	32%	56%
Small Savings & PF	24%	30%	34%	43%	33%
Dues to GOI	58%	46%	42%	26%	12%
Others	-5%	5%	5%	8%	6%
Debt/RR	165%	207%	197%	295%	317%
Debt/GSDP	26%	30%	28%	37%	44%
Debt/Income per capita	31%	33%	32%	39%	45%
Cont. Liabilities (Rs. Cr)		1405	2082	9553	12316
Social Services/RE	55%	46%	40%	36%	
General Services/RE	28%	34%	39%	45%	

Debt Sustainability

- GOI's twin criteria for 'debt stress':
 - Debt/Revenue Receipts > 300%
 - Interest payments/Revenue Receipts > 20%
- Kerala classified as debt-stressed using either criteria.
- Debt stressed States penalized through restricted access to EAPs
- Domar debt sustainability equation:
 - GDP growth rate should exceed average interest on debt
 - Where $R > \text{GDPgr}$, Primary balance should be positive or only nominally negative.
 - Where $R > \text{GDPgr}$ and primary balance is negative, seigniorage > Primary deficit.
- Since tax buoyancies vary and State income data not as reliable as fiscal data, RR growth rate can also be used instead of GSDP?
- 2001-04: State's Domar gap negative in relation to GSDP, but positive relative to Revenues.

Debt Stress of States: 2001-04 Average

Non-Special Category State	Domar Gap		Primary Deficit		Debt/RR	VRR
	GSDP	RR	Rs. Cr.	% GSDP		
Andhra Pradesh	1.05	3.59	2085	1.9	237	17.3
Karnataka	-1.09	3.09	2085	1.8	208	18
Tamil Nadu	-2.54	0.4	2110	1.4	206	16.9
Kerala	-0.54	1.52	1712	2.1	319	27.5
Gujarat	8.71	-1.72	3656	2.6	316	20.5
Maharashtra	4.85	-1.69	8401	2.8	287	18.6
Goa	-2.51	-4.14	125	1.5	204	16.3
Average Peninsular	1.1	0.2	2882	2	253.9	19.3
NCT Delhi	7.39	7.81	1859	2.5	185	4.8
Punjab	-0.76	3.02	2282	3.1	379	23.6
Haryana	2.66	6.16	868	1.3	227	17.4
Average High Income Northern	3.10	5.66	1670	2	263.7	15.3
West Bengal	-0.1	-6.05	4109	2.5	503	50
Orissa	1.81	1.24	679	1.5	362	33.9
Bihar	-1.9	-1.76	1295	2.5	328	26
Jharkhand	5.59	-0.47	975	2.7	170	12.2
Madhya Pradesh	2.74	-6.07	2457	2.7	241	19.6
Rajasthan	1.84	-0.58	2718	2.9	191	14.6
Uttar Pradesh	0.13	0.79	4119	2	348	27.3
Average Low Income Northern	1.4	-1.8	2336.0	2.4	378	27.8

Changing State Debt Portfolio

Table XXII: Components of Outstanding Liabilities of State Governments

(per cent to total)

Components of Outstanding Liabilities	End-March 1991	End-March 2000	End-March 2004	End-March 2005
1	2	3	4	5
1. Internal Debt	15.0	22.9	46.4	50.4
<i>of which:</i>				
(i) Market Loans	12.2	14.9	19.5	20.5
(ii) Small Savings (NSSF)	—	5.2	18.2	21.3
(iii) Loans from Banks & Financial Institutions*	2.0	3.4	6.6	6.8
2. Loans and Advances from the Centre	57.4	46.6	29.1	26.3
3. Public Account Liabilities	26.9	30.1	24.5	23.3
<i>of which:</i>				
(i) State Small Savings & Provident Funds	13.2	15.9	13.3	12.9
(ii) Reserve Funds	3.7	3.9	4.2	4.3
(iii) Deposits and Advances	10.0	10.3	7.0	6.1
4. Contingency Fund	0.8	0.3	0.0	0.0

Financing of Government Expenditure

(as percentage of total expenditure)

<i>Indicator</i>	88-89	89-90	98-99	99-00	05-06	06-07BE	XI Plan
Revenue	90.5%	83.6%	70.0%	63.4%	78.3%	71.5%	76.9%
Own Revenue	62.6%	59.6%	50.7%	45.7%	54.8%	47.8%	58.3%
Own Taxes	45.7%	46.1%	45.2%	41.4%	50.1%	43.6%	54.1%
Own Non-Tax	16.9%	13.4%	5.4%	4.2%	4.8%	4.2%	4.2%
Central Transfers	27.9%	24.0%	19.4%	17.7%	23.4%	23.8%	18.6%
XII FC Award							14.5%
Borrowings	17.6%	21.8%	28.1%	34.4%	24.1%	25.1%	20.7%
Internal debt (Incl.NSSF)	5.5%		8.2%	10.5%	19.1%		
GOI	5.2%		6.4%	2.0%	-0.2%		
Others (non-interest)	0.0%		0.6%	-1.3%	4.8%		
State Public Account	6.9%		13.0%	23.2%	0.3%	3.9%	

Financing Government Expenditure

- Increasing reliance on borrowings
- Increasing reliance on market borrowings
- Declining importance of State ('banking') Public Account
- Sharp decline in central loans
- Sharp decline in own revenue buoyancy, both tax and non-tax, over the last decade.
- Sharp decline in central transfers
- Temporary improvement of liquidity on account of XII FC award and NSSF flows
- Declining NSSF flows queer the pitch
- XII FC recommendations on borrowings queer the pitch

Sources of Revenue Growth

	86-91	91-96	96-01	01-06	XI Plan
Revenue Buoyancy	0.92	1	0.83	1.17	0.87
Own Tax Buoyancy	0.98	1.14	0.96	0.98	1.15
Own Revenue Buoyancy	0.94	1.14	0.89	0.89	1.07
Real GSDP growth	5.7%	7.2%	5.0%	7.7%	8.0%

SWOT Analysis of State Finances

• Strengths

- External Remittances
- Lesser reliance on GOI & Public Account
- High per capita consumption
- Robust growth
- Private Investment
- High HDI Index and good governance
- Healthy Power Utility
- Adherence to guarantee caps
- Tertiary Sector
- Reasonably good infrastructure
- Large # Commercial bank branches

• Opportunities

- New Infrastructure projects
- Location on east-west sea-trade route
- Domestic private investment
- Foreign Investment
- NRKs
- Tertiary sector: tourism, outsourcing & biotechnology
- Combined VAT and Services Tax
- Robust growth rate conducive for fiscal adjustment
- Robust financial sector conducive for pension reform

• Weaknesses

- Symptoms of Dutch Disease
- Debt Overhang
- Weak State PSUs
- Industry and agriculture
- SPI rigidities
- Low tax buoyancy
- Falling Social sector, Plan and K expenditure
- Falling central assistance
- Poor investment image and low FDI
- Dispersed settlement pattern
- Limited land availability
- Cannot tap external markets directly

• Threats

- Pay Commission award
- Mandated devolutions to Local Bodies
- Expanding public sector employment
- Ageing society
- Pension time bomb
- XII FC Borrowing recommendations
 - Market access
 - Shortening maturity profile of debt
- Decline in NSSF Flows
- Rising interest rates
- External Shock
- Commodity price volatility & agrarian Crisis

Regional Fiscal Pattern: 2001-04 average

States	GSDP GR	GFD/	RD/	RD/	OTR/	ONTR/	CT/	DEBT/
Non Special Category	K Prices	GSDP	GSDP	GFD	GSDP	GSDP	GSDP	GSDP
1 Andhra Pradesh	4.9	4.4	1.8	40.9	7.9	2	4.6	34.3
8 Karnataka	4.7	4.4	1.9	39.2	9.1	1.4	3.9	29.8
16 Tamil Nadu	1.5	3.7	2	52.6	9.3	1.2	3.1	27.9
9 Kerala	7.2	5.6	4.3	76.2	8.7	0.8	3.4	41.3
5 Gujarat	11.1	5.1	3.4	67.5	7	2.6	2.6	38.6
11 Maharashtra	6.7	4.8	2.9	62.4	7.7	1.4	1.5	30.7
4 Goa	5.5	4.7	2.1	43.7	7.2	11.2	2.1	41.2
UW Average Peninsular	5.9	4.7	2.6	54.6	8.1	2.9	3.0	34.8
12 NCT Delhi	6.7	2.9	-2.4	-82.9	7.1	1.2	0.7	16.5
14 Punjab	2.8	6.5	5.1	78.2	7.6	5.3	1.7	54.9
6 Haryana	6.3	3.6	1	31.5	8.3	2.8	1.7	29.3
UW Average HI North	5.3	4.3	1.2	8.9	7.7	3.1	1.4	33.6
18 West Bengal	7.2	6.9	5.3	75.9	4.4	0.4	4.2	45
13 Orissa	6.8	7.5	4.3	55.7	6.2	1.9	9.7	64.2
2 Bihar	0.9	8.3	3.8	45.1	5.4	0.7	16.2	73.3
7 Jharkhand	8.4	5	0.1	0.2	6	2.8	10.1	32
10 Madhya Pradesh	7.2	5.5	3.2	58.9	6.6	1.8	6.2	35
3 Chhattisgarh	10.8	4.1	1.3	30.5	7	2.8	6.1	30.3
15 Rajasthan	8.4	6.9	4.1	58.9	6.9	1.8	5.9	51
17 Uttar Pradesh	3	6	4.9	76	6.2	1	7.1	54.1
UW Average LI North	6.6	6.3	3.4	50.2	6.1	1.7	8.2	48.1

Kerala's Fisc in Comparative Perspective

- High own tax revenues as % of State Income
- Tax burden relatively low as percentage of consumption
- Very low non tax revenue
- Relatively high growth
- High Debt overhang
- Fiscal parameters out of synch with other peninsular States

Fiscal Adjustment under XII FC

- Fiscal responsibility legislation setting statutory limits on RD, FD and contingent liabilities, with interest relief and debt consolidation as incentive (availed by the State in 2005-06)
- 12th FC has targeted 0% RD by March 2009 and 3% FD for all States, with debt waiver as incentive. State could claim debt waiver of about Rs. 1500 Crore
- State unlikely to attain these benchmarks.
- Borrowing recommendations of Fiscal Responsibility legislation and XII FC likely to push State towards fiscal adjustment:
 - Revenue side
 - Expenditure side

Fiscal Adjustment : Revenue side

- Tax Revenues
 - Own tax revenue relatively high as proportion of GSDP (which does not capture external remittances), and relatively low as proportion of consumption (which captures external remittances)
 - Declining tax buoyancy in recent years, possibly aggravated by switch over to VAT
 - GOI VAT compensation on reducing basis for three years
 - Over the medium to long-term VAT, esp. after introduction of single product and services VAT, should improve tax buoyancy.
- Non-Tax Revenues
 - Kerala lagging far behind other states in augmenting non-tax revenues.
 - Recovery of user charges to cover delivery costs.
 - Increasing yields from public assets (lease charges, dividends from PSUs.)

Fiscal Adjustment: Expenditure Side

- Major adjustments unavoidable on the expenditure side.
- Expenditure rigidities to be addressed: salary, pension, interest and non-merit subsidies.
 - New posts in Government and Government funded organizations through redeployment only over the short-run.
 - Focus on right-sizing public employment and emoluments over the long-term.
 - Major pension reforms.
 - Reducing of non-merit subsidies and targeting merit-subsidies.
 - Improving fiscal health of State-owned utilities and PSUs.
 - Strategic management of debt portfolio to contain borrowing costs.
- Increased private investment to exercise countervailing influence on reduction in Government expenditure and employment.

Financing Position 2006-07

	2005-06	% of Total	2006-07	% of Total	% Increase
			Budget		
Tax Revenue	12116	59%	14690	53%	21.2%
Sales Tax	7038	34%	8130	30%	15.5%
Excise	841	4%	945	3%	12.3%
MVT	629	3%	760	3%	20.9%
Reg&Stamps	1101	5%	1400	5%	27.1%
Elec.Duty	32	0.2%	266	1%	742.9%
Other State Taxes	138	1%	163	1%	18.2%
Share in Federal Taxes	2338	11%	3027	11%	29.5%
Non-Tax Revenue	2378	12%	4360	16%	83.4%
Non Plan Central Grants			690	3%	
Vat Compensation			1067	4%	
Plan Grants+CSS	2023	10%	1581	6%	-21.9%
Lotteries	165	1%	161	1%	-2.4%
Forests	190	1%	250	1%	32.0%
Education	85	0.4%	104	0%	22.4%
Others	403	2%	507	2%	26.0%
Borrowings (gross)	5957	29%	8481	31%	42.4%
OMB	1806	9%	1794	7%	-0.7%
Neg. Loans	630	3%	930	3%	47.6%
Central loans/EAPs	543	3%	979	4%	80.4%
Public Account	300	1%	1744	6%	481.3%
NSSF	2678	13%	3000	11%	12.0%
NCDC			34		
Total Resources	20451	100	27531	135	34.6%

Kerala: Growth

	1993-94	1996-97	2001-02	2005-06
Agric/GSDP	31%	30%	19%	15%
Industry/GSDP	21%	21%	22%	24%
Services/GSDP	49%	49%	59%	61%
GSDP PC at 93-94 Prices	8761	9905	12110	16481
3YMA GSDP Gr at 93-94 Prices		4.2%	4.3%	8.2%

Kerala Model: Indicators

Amartya Sen and Jean Dr'eze: HDI comparable to developed countries despite relatively low per capita income. National HDI Rank # 3 (NHDR 2001)

	Kerala	India
Settlement Pattern	Rurban	Urban - Rural
Land reforms	Successful	Partial
Growth Rate	6%	6%
Income Poverty (99-00)	12%	26%
Per capita consumption (99-00)	Rs. 816	Rs. 591
Telephone density per 1000	68	32
Literacy (2001)	91	65
Sex Ratio (2001)	1058	933
Life Expectancy (92-96)	73	61
Infant Mortality (1991)	42	77
Per capita elect. Consumption (96-97)	241 KwH	334 KwH
Unemployment (99-00)	8.6%	2.3%
Services Sector	61%	52%

Burden of States' Own Taxes per capita

	03-04	99-00
	OT/GSDP	OT/Cons.
Andhra Pradesh	7.6%	17.9%
Karnataka	9.5%	19.1%
Tamil Nadu	9.5%	21.4%
Kerala	9.0%	16.7%
Gujarat	6.7%	19.8%
Maharashtra	7.6%	21.3%
Goa		27.9%
Average Peninsular	8.3%	20.6%
NCT Delhi	7.0%	15.7%
Punjab	7.9%	17.1%
Haryana	8.5%	18.1%
Average High Income Northern	7.8%	17.0%
West Bengal	4.6%	9.3%
Orissa	6.1%	9.3%
Bihar	6.0%	8.7%
Jharkhand	5.6%	
Madhya Pradesh	6.7%	16.7%
Chhattisgarh	6.7%	
Rajasthan	6.9%	10.9%
Uttar Pradesh	6.3%	9.1%
Average Low Income Northern	6.1%	10.7%
National Average	6.3%	14.1%

Kerala: Remittance Economy

1999-00: State per capita Net income 13% and consumption 38% above National Average

• Pros

- Safety valve for high chronic **unemployment**
- **Counter-cyclical** effect
- Increases **consumption**:
 - lower poverty
 - higher expenditure on health, education etc.
- Higher **growth** through more investment (construction boom)
- Improves **public finances**
 - Sales tax, VAT and excise revenues
 - Contains potential fiscal expenditures arising out of high unemployment, poverty, etc.

• Cons

- Depresses **domestic savings** by creating illusion of household financial stability
- Vulnerability to external **shocks**
- **Wage inflation** has negative impact on investment and growth: Symptoms of Dutch Disease.
- **Moral hazard** – diminishing pressure for reform

Kerala: Economic Challenges

- **Growth neutral Fiscal** correction: Deficit reduction countervailed by using limited public resources to leverage more private investment through PPP route. Good regulatory framework and arms-length regulator essential.
- **Redirect public expenditure**
 - Maintain/upgrade Infrastructure (such as 24X7 clean piped water, waste disposal systems)
 - Address second-generation 'quality' problems in social sector
- Target **high unemployment** by:
 - Leveraging major **PPP/BOT** infrastructure investment taking place over next 5 years.
 - Address crisis in **agricultural and Traditional** sectors
 - Creating **investor friendly climate** to crowd in more private investment, especially in the booming services sector
 - Tourism
 - IT and biotechnology
 - Healthcare
 - Addressing **skills mismatch**
 - High white collar unemployment rate
 - Export of labour
 - Import of blue collar labour