

SUB-NATIONAL FISCAL SUSTAINABILITY IN A GLOBALISED SETTING

N. J. Kurian and Jacob John

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CSP

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This collection of papers addresses the issues of fiscal federalism, centre-state relations, fiscal decentralization, unconventional methods of resource mobilization for filling the huge gap in infrastructure financing and strategies for achieving fiscal sustainability at the national and sub-national level in the globalized setting. Though a number of articles are in the context of Kerala, the overarching fiscal problems of sub-national governments are common to all. It contains detailed and in-depth analysis by eminent scholars and seasoned economic administrators, based on empirical and theoretical studies.

Six decades of federal fiscal arrangement in India has resulted in centralization of fiscal powers, increase in regional imbalances and increased vertical and horizontal imbalances. Central and state government finances came under great stress during the last decade, and the situation continued in the early years of the current decade on account of a variety of reasons. The five-year period since 2003-04, however, saw significant fiscal correction and consolidation at the central and state levels. The still-unfolding implications of the global financial and economic crisis on the union and state finances are going to be severe. Both the centre and the states may take years before the targets of deficits set for March 2009 under fiscal responsibility legislations could be realized.

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SUB-NATIONAL FISCAL SUSTAINABILITY IN A GLOBALIZED SETTING: AN OVERVIEW

N.J. KURIAN AND JACOB JOHN

Various dimensions of fiscal issues in India have changed in the post-liberalization period. Savings-investments constraints no longer exist in the country and there has been substantial increase in the financial flows and investable resources. A high rate of foreign direct investment and the increasing funds from foreign institutional investors have made substantial improvement in the fiscal scenario of the country. When the huge fiscal deficit of both national and sub-national governments reached unsustainable proportions, to restrain the fiscal profligacy at national and sub-national level, the Fiscal Responsibility and Budget Management (FRBM) Act, 2003, was passed in the Indian Parliament, and it came into effect in July 2004. The objective of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003, was to control the political leadership's financial profligacy. The FRBM Act mandates gradual elimination of government borrowing for any purpose other than public investment by 2009, and restricts the total amount of such borrowing per year to no more than 3% of GDP. All the state governments are required to enact laws in line with the central Act. As a part of various policy initiatives to provide economic stimulus to beat the impact of the economic slowdown, states have been allowed to modify their laws to fix fiscal deficit target at 3.5% of state GDP for the financial year 2009-10.

This volume deals with various aspects of fiscal federalism, centre-state relations, fiscal decentralization, unconventional methods of resource mobilization for filling the huge gap in infrastructure financing and strategies for achieving fiscal sustainability at the national and sub-national level in the globalized setting. It comprises 11 essays that deal with various aspects of India's fiscal issues. Though most of the articles are in the context of Kerala, the overarching fiscal problems of sub-national governments are common to all states.

The book starts with an essay by the editors, N.J. Kurian and Jacob John, which outlines the broad framework of the volume. It discusses various aspects of sub-national fiscal sustainability in India. Six decades of federal fiscal arrangement in India has resulted in centralization of fiscal powers, increase in regional imbalances and increased vertical and horizontal imbalance. Central and state government finances came under great stress during the latter part of the last decade, and the situation continued in the early years of the current decade on account of a variety of reasons. The five-year plan period since 2003-04, however, saw significant fiscal correction and consolidation at the central and state levels. Apart from other factors, the Fiscal Responsibility and Budget Management (FRBM) Act, 2003, of the centre and similar Acts of the states contributed to fiscal correction during this period. This situation has undergone a sea-change over the last one year. The paper cautions that the still-unfolding implications of the global financial and economic crisis on the union and state finances are going to be severe. Both the centre and the states may take years before the FRBM targets of deficits set for March 2009 could be realized.

Issues related to sub-national fiscal sustainability of the Indian states have been discussed with special reference to Kerala. Kerala has the distinction of having achieved a fairly high level of human and social development at a relatively low level of economic development. The 'Kerala Model of Development' has, indeed, been universally acclaimed. States like Kerala suffer from adverse implications of FRBM targets in view of long-term commitments to social-sector spending and periodic pay revisions. The impact of the current global crisis is likely to be more severe on the economy and public finance of Kerala than on most other Indian states because of the fact that the economy of Kerala has much more exposure to the world economy. Unlike most other states, Kerala had given high priority to social infrastructure and low priority to economic infrastructure in its public investments in the past. This has resulted in a high level of social and human development with relatively unimpressive economic development. Ensuring fiscal sustainability of Kerala in a globalizing context is going to be a great challenge in the coming years.

The paper by Alok Sheel discusses three broad categories of funding sources of Indian states, namely, tax receipts, non-tax receipts and borrowings. Tax and non-tax receipts together constitute the state's revenue. The state's non-tax revenue is derived from user charges levied for public services such as education, health and other administrative charges, and from the commercial operations of state-owned enterprises.

Non-tax revenue receipts from the centre are in the form of grants. The state cannot directly access foreign borrowings or grants except through the central government, or with its prior permission. Alok Sheel brings out the recent trend of states moving towards 'indirect' government expenditure when government, instead of spending taxpayer revenues, uses various kinds of 'public-private partnerships' (PPPs) in infrastructure and social investment. The central government also encourages and facilitates such public-private partnerships through a viability-gap funding window through which central assistance can be given to fill up to 20% of the viability gap in infrastructural projects. After discussing the broad framework of state finances, the author takes up the cases of Kerala for detailed examination. Since Kerala is not a major manufacturing hub, the tertiary sector and overseas migration have taken on a part of its function in creating more productive jobs. The primary sector's productivity has stagnated, and its share in the state income has declined sharply from about 20% to 15% in the last five years. Kerala has been a major beneficiary of globalization since exports of labour, plantation crops and marine products and tourism inject substantial income into its economy. This outward orientation, by its very nature, can also be potentially destabilizing and volatile. External remittances are double-edged since, while they provide a valuable cushion against unemployment, they also create symptoms of the 'Dutch Disease' through wage inflation, lower investment and depress domestic savings by creating an illusion of household as well as public financial stability that could be easily destabilized in a worsening external environment.

While discussing different features of public finances of Kerala, a major consuming state in the country, Sheel elaborates the state's daunting rigidities on the expenditure side, with expenditures on salary, pensions and interest (SPI) soaring year after year and, as a result, the state debt rising sharply and continuously over the last several years. Though the recent improvement in public finance indicators of Kerala was achieved in a favourable macro-economic environment of high growth, low inflation and declining interest rates, this macro-economic environment is currently threatened by potentially stagflationary conditions. The average annual growth rate of the Indian economy during the Tenth Plan period is estimated to be 7.6%, and Kerala's growth rate is estimated to be slightly higher at 8%. The benefits of growth have been passed on unequally to different sections of society. The agricultural crisis in the state has been magnified on account of its greater reliance on internationally traded commodities such as tea, coffee, rubber, cashew, spices and coconut. It is a matter of concern that a durable strategy to address the

underlying price volatility leading to persistent indebtedness among farmers is still missing. Moreover, the rollback of social-sector expenditures may have magnified the crisis. The crisis in the agricultural and traditional sectors would exert fiscal pressure and reprioritizing of public expenditures in the near future. The paper suggests that major infrastructural projects such as seaports, airports and roads of international standard need to be funded through a combination of tax revenues and PPPs. The paper concludes that the introduction of the Value-Added Tax (VAT) would improve and stabilize the state's own tax buoyancy and, moreover, the movement towards a unified Goods and Services Tax (GST) could improve the state's finances, given the structure of the state's economy as a major hub for final consumption.

P.V. Rajeev, in his paper, examines the various components of resource mobilization of the Federal Government of India. The paper, in view of the shortage of financial resources to implement Plan programmes, discusses the policy issues involved in the resource mobilization policy in relation to personal income tax, agricultural income tax, corporate tax, excise duty, service tax, customs duty, public borrowings and administered prices and subsidies. The paper raises concern over the slow progress in the implementation of the Long-Term Fiscal Policy of the Government of India, which had been attributed the lack of buoyancy in income tax revenues to several factors, including narrow coverage of the working population, numerous exemptions and deductions and widespread evasion. The policy document had also rightly realized the need for rationalizing and simplifying the tax laws to make the provisions easier to administer and curb tax evasion.

The paper discusses the various aspects of tax reforms in the country. It was in 1994-95 that service tax was introduced to redress the asymmetric and distortionary treatment of goods and services in the tax framework and to widen the tax net. The number of commodities covered by this tax has increased from 3 in 1994-95 to more than 100 today. India has adopted a system of dual value-added tax (VAT): The central VAT (CenVat) at the federal level, and the state VAT at the state level. The most important of state taxes is state VAT. It has been proposed to introduce a combined national-level goods and services tax (GST) with effect from April 1, 2010, to avoid double taxation and tax cascading. It provides for input tax credit at every stage for tax already paid till the previous transaction. This will also attempt to provide a rational system by subsuming several state-level and central-level indirect taxes on goods and service. It is expected that GST will provide a simple and progressive taxation system for goods as well as services. According to the author,

non-introduction of Agricultural Income Tax leads to inequity in the scheme of income tax as a whole as it favours the rich agriculturists against the poor in the rural sector. The major weakness of India's Corporate Tax structure is the complexity of the structure itself. The frequent changes made in the excise duty rates are an unhealthy feature of excise taxation in India. The reduction of the large number of both explicit and hidden subsidies in India can release enormous resources for investment.

Pinaki Chakraborty brings out in this volume an overview of finances of Indian states in the context of reforms and fiscal sustainability, with special reference to Kerala. The all-state fiscal deficits as a percentage of revenue deficits reached a level as high as 57.1% between 1998-99 and 2003-04. This means that more than 57% of the current borrowing was used for consumption expenditure purposes by the states. The fiscal situation of all Indian states witnessed a decline in the second half of the last decade and the first few years of the current decade. There has been a significant improvement in the fiscal situation of the states during the last few years. This is reflected in reduced gross fiscal deficit and revenue deficit. Further, capital expenditure has increased considerably and revenue deficit as a share of borrowings has come down significantly. Fiscal deficit, driven by current consumption expenditure, is unsustainable in the long run. Kerala's fiscal profile historically is driven by high social-sector expenditure, which is largely revenue expenditure in nature. The outstanding debt to GSDP ratio for Kerala increased sharply over the years, which was around 25% in 1987-88, and increased to 43% by the end of 2004-05. In the next two years, it remained at that level. Large debt-overhang invariably reduces the fiscal space for productive government expenditure. The debt structure is increasingly getting skewed towards shorter-dated maturity. This implies that Kerala is contracting more debt at shorter end of the government securities market. This has the potential risk of frequent repayment problem and also eventual rolling over and unsustainability of debt. Pinaki Chakraborty raises concern about the fiscal sustainability of the state, in the long run, in the face of massive fiscal strain generated through higher debt-servicing obligations.

The paper concludes that though Kerala has a large fiscal imbalance compared to many other states, the fiscal situation would not be unsustainable if the state maintains its high revenue effort and carry out expenditure rationalization. It is likely that Kerala would have a higher level of sustainable deficit with a high revenue effort. Its debt sustainability exercise says that even the current fiscal stance is sustainable in the long run. The paper suggests that the state needs to improve its

revenue performance, particularly with regard to non-tax revenues from various public services as recovery rates are very low. In order to sustain the buoyant growth of Kerala's economy, higher revenue effort, expenditure rationalization and altering expenditure pattern towards capital expenditure would be critical. A sustained increase in capital expenditure would also help Kerala economy in terms of higher growth by meeting its physical infrastructure needs. The author has suggested that the state needs to improve its revenue performance to increase the fiscal space quickly for productive government expenditure.

N.D. George's paper focuses on the fiscal situation of Kerala and examines how far the state's fiscal problems constrain its essential public investments. Public investment by the central, state and local governments in India still plays a vital role in the economic development since the public sector is the major provider of physical infrastructure. However, state governments are mainly responsible for providing most of the physical and social infrastructure. The paper discusses two main sources of resources of Indian state governments – state's own resources (SOR) and central assistance (CA) – for generating financial resources for investment. The major components of SOR are balance from current revenues (BCR), state provident funds, loan against net small savings, market borrowings and negotiated loans from financial institutions. CA comprises normal central assistance (NCA), additional central assistance for externally aided projects and additional central assistance for specific central sector programmes. While states such as Rajasthan, Tamil Nadu and Uttar Pradesh reduced their negative balances in the BCR, Kerala's position worsened from Rs (-) 1,892 crore in 2002-03 to Rs (-) 3,946 crore as per 2006-07 estimates. This shows that Kerala is not able to capitalize on the general growth momentum in the country and use it for the much-needed fiscal correction. Based on the data analysis, it is shown that most Indian states improved their BCR status by 2006-07 on account of the increased central transfers resulting from the Twelfth Finance Commission and the increased own revenue receipts.

In view of the worsening fiscal situation in Kerala, the state is fiscally weak to make any major public investment in physical and social infrastructure. In fact, public investment in the state is a meager 3.7% of the state's GSDP as fiscal constraints squeeze capital expenditure. The scope for reducing expenditure is limited as it is mainly of salaries, pensions and interest payments. N.D. George argues that the challenge before the Government of Kerala is to channelise the large amount of fund available in the state into investment either through the public sector or through the private sector or a combination of both, by putting in place

appropriate policy regimes. The paper concludes with a package of concrete recommendations to the state for re-orienting its priorities and earmarks its energies and resources. These include an appropriate policy regime for public-private partnership investment in infrastructure sector, improved efficiency of public investment, and shifting of available resources to vital functions such as the creation of public infrastructure and their proper maintenance.

K.P. Sunny, in his paper, captures the various aspects of fiscal management in Nagaland, one of the Special Category (SC) states in the North-East region of India. While stating that Nagaland is relatively a better-performing state in terms of fiscal resource management and implementation of fiscal reforms, he presents an overview of the difficulties of the state in achieving the targets laid down in the FRBM Act, 2005. The paper provides a comparative performance of select states under General Category as well as Special Category in terms of revenue and fiscal deficits. While all the North-Eastern states are under-taxed in comparison to other Indian states, there is good scope for enhancing the rates of taxes. These include sales tax, land revenues, motor vehicles tax, passenger tax and goods tax, electricity duty, etc. There is also scope for the imposition or enhancement of user charges for various utilities.

Even in Nagaland, a relatively better-performing state in terms of fiscal resource management and implementation of fiscal reforms, it would be difficult to achieve the targets laid down in the FRBM Act of 2005 at the current level of tax and non-tax revenue. The state needs the support of the central government in the form of policy changes. Nagaland and a few other states in the North-East such as Arunachal Pradesh, Manipur, Meghalaya, Mizoram and Tripura were created out of political necessity to meet the people's aspirations without taking into account the fiscal viability of each state. Further, these states are dominated by the tribal population and they were exempted from paying income tax under the plea that generally they were very poor. The situation has, however, changed now. Income levels of certain sections of the population, particularly the government employees and service-providers, have risen to a level to attract income tax. K.P. Sunny's paper concludes that, while the ultimate responsibility for fiscal adjustment lies with the states, the federal government of India has a critical role to play, especially in the case of Special Category states like Nagaland. The centre should promote expenditure and tax reforms and strengthen the federal fiscal framework to enable states to have both the resources to develop and the incentives to perform.

Deepa Sankar, in her paper, analyses the trends in social-sector expenditures in Kerala, especially in recent years in the context of the state's increasing burden on non-developmental expenditures and its effect on the human development indicators. The mechanisms of financing of social-sector programmes, in general, in India and the changing roles of the centre and the states are analyzed in the paper. While analyzing the trends in revenue expenditures and the intra-sectoral allocations in social-sector revenue expenditures, various social-sector issues are discussed. The paper by Deepa Sankar also discusses the changing modes of financing social-sector expenditures in India. Though health and education are subjects of concurrent jurisdiction of the central and state governments, basic health services and primary education are generally the duty of the state governments. The paper brings out in this volume the multiple sources of funds for social-sector financing, that is, states' own revenues, which cover both tax revenues and non-tax revenues, the statutory transfers of the central government, the central assistance for the state plan and the Centrally Sponsored Schemes. A comparison between expenditures on social sector and general services categories brings out the relative increase in general services since the late 1990s. While the increase in interest payments and pensions is quite significant, the growth of revenue expenditures in social-sector services like education and health remains modest.

Deepa Sankar's paper raises serious concerns about the increase in the burden of interest payments and other general service expenditures in government's revenue expenditures, which are non-developmental in nature. Kerala has not been able to increase the social-sector allocations to reflect the increasing revenue generation, and the social-sector spending is mainly in the nature of recurrent expenditures. The author emphasizes the need to examine the service delivery and accountability framework in social sectors so that the focus shifts from outlays to outcomes.

The contribution by V. Suresh, while discussing the strategy for enhancing financial investments in housing, infrastructure and other development sectors for Kerala, informs us about Kerala's urbanization, which is on a lower trajectory in comparison with the national urbanization trends. This is due to the balanced growth of the rural and urban areas in Kerala, which has a unique settlement pattern with a rural-urban continuum with good transport connectivity. The urbanization is of the order of 26%, with 5 municipal corporations and 53 municipalities.

The paper takes the view that, considering infrastructure needs of the state and the limited resources of the public sector, it is desirable to provide an enabling framework for other investment and delivery options.

The public-private-people's-partnership models for economic and social development needs to be increasingly encouraged with an appropriate regulatory mechanism which would strengthen such partnership models in a sustainable manner. The paper brings out some concrete suggestions. The financial position of all of Kerala's urban local bodies – municipal corporations, municipalities, development authorities and other parastatals – should be improved. Accessing enhanced funding from Central Government / other sources JNNURM / IHSDP and funds for small and medium towns from the Ministry of Urban Development and the Ministry of Housing and Urban Poverty Alleviation should be fully availed for all eligible cities, through funding support for many project / reform initiatives. The urban local bodies and parastatals should utilize all the potential user charges for the nature of service made available. The state government and urban local bodies should tap the bond market for raising resources through special bonds for urban infrastructure and city development needs. The author emphasizes the need for setting up a regulatory authority for housing and infrastructure.

As M.A.Oommen brings out in this volume, the 73rd Constitutional Amendment (the panchayat amendment) of 1992 was made to implement the directives laid down in Article 40 to make village panchayats 'units of self-government.' While there is substantial progress in political decentralization, fiscal decentralization has been lagging behind. The paper discusses the conceptual framework of fiscal decentralization in India, outlining the four basic issues relevant in the multi-level federal polity of India. These issues are related to assignment of expenditure responsibilities, revenue assignments, efficient and equitable transfer system, and accountability mechanism. The author raises certain critical issues that need be addressed to rectify the current situation and strengthen the decentralization process in India. These include lagging political will, poor progress in activity mapping, lack of relevant budgetary reforms, failure of State Finance Commissions, and non-viability of village panchayats.

M.A.Oommen's paper suggested that budget of each state should create 'panchayat windows' for each department or appropriate account heads. State Finance Commissions should determine the divisible pool of resources to be distributed among the different tiers of local government institutions and fix the principles for *inter se* devolution. The paper emphasizes the need for raising own resources as the best way to ensure meaningful functional, fiscal and administrative autonomy. There is an urgent need to build a strong database on the panchayat revenue, expenditure and borrowing. The majority of village panchayats are not

viable in terms of revenue base or in scale economics in the delivery of basic services, with the average size of population of a village panchayat around 3,400. Hence it is important to make village panchayats viable by restructuring the size to enhance their efficiency and viability.

According to C.N.S.Nair, Panchayati Raj Institutions (PRIs) – the rural local governments – in Kerala can play a significant role in promoting the inflow of foreign and domestic investment in view of the low impact of the state government's promotional efforts. Kerala is a front-running Indian state having a strong local government system to which considerable powers and resources have been transferred. Kerala has been catching global attention for many years for its human development achievements. In the 'Kerala Model' of development, human development achievements have been far more impressive than growth in incomes. Hence Kerala should take steps to accelerate investment, especially by attracting domestic and foreign investment. The paper argues that, as all Indian states are competing for investment, the Kerala government's investment promotion activities could be sustained over a period of time with the active involvement of PRIs. With this strategy, Kerala might succeed in attracting huge investment funds which, in turn, can help the state match its social development achievements with creditable economic performance.

The paper suggests that local panchayat leaders and other influential persons should interact with the high-net-worth Non-Resident Keralites (NRKs) and offer them incentives to set up enterprises. PRIs should identify potential investors among Non-Resident Indians and build a new relationship of trust. Groups of NRKs, especially the high-net-worth and the investment-seeking, should be invited to visit Kerala, and PRIs should accord them a warm welcome. PRIs should maintain a directory of such NRKs and also carry on a continuing dialogue with them. The paper concludes that, with the active involvement of PRIs, Kerala might succeed in matching its social development achievements with equally creditable economic performance.

Jacob John and Ruchi Jain bring out certain issues regarding mobilization and utilization of funds by PRIs in the Union Territories (UTs). In India, UTs are governed directly by the central government. As the five UTs – the Andaman and Nicobar Islands, Chandigarh, Daman and Diu, Dadra and Nagar Haveli, and Lakshadweep – do not have legislature, the Ministry of Home Affairs of the Central Government prepares their budgets and gets the budgets passed by the budgetary allocation from the Consolidated Fund of the Government of India in Parliament. Once the budget is passed, the UT administrator can spend the fund, and the UT

administrators have more administrative freedom in spending the fund compared to the states in the country. In this situation, PRIs in the five UTs have been grappling with many complex problems – structural, administrative and fiscal. The paper examines the essential features of the PRI system in the five UTs, analyzes the mobilization and utilization of funds by PRIs and suggests concrete measures to improve their functioning.

The paper by Jacob John and Ruchi Jain reveals that, though the administrative bodies of all the five UTs have specified that functions be transferred to PRIs, this is not being executed. In the absence of legislature, the UT administrator and the bureaucracy have been holding powers. A huge amount of funds available with PRIs remain unspent every year primarily due to the lack of functions and functionaries. Significantly, the accumulated, unspent balance with the PRIs has had an adverse effect on mobilization of own source of revenue. Certain concrete steps that are essential to improve fund mobilization and utilization by the PRI system in the five UTs have been suggested. Own source of revenue needs to be mobilized by strengthening tax assessment and collection process. The study highlights the urgency for the removal of the mismatch between activity mapping and corresponding funding of PRIs under various budget heads of the UTs.

Besides maintaining the social infrastructure, the state has an urgent need for considerable investment in economic infrastructure. In the immediate context, the chances of attracting private investment for economic infrastructure are not too bright. Ensuring fiscal sustainability of Kerala in a globalizing context is going to be a great challenge in the coming years.

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CHAPTER TWO FINANCING GOVERNMENT EXPENDITURE WITH SPECIAL REFERENCE TO KERALA

ALOK SHEEL

Introduction

State government expenditure in India is primarily funded through taxes. In addition, the state collects user charges for public services rendered and receives grants from the federal government for specified purposes. It cannot directly access funds from overseas agencies. Tax revenues, in turn, comprise current receipts and borrowings against future revenue streams. The latter constitute the fiscal deficit, which is sometimes described as a deferred tax.

The state's funding sources can, therefore, be divided into three broad categories, namely, tax receipts, non-tax receipts and borrowings. Tax and non-tax receipts together constitute the state's revenue. Each source of revenue is mobilised either from within the state or from the Centre. Thus, the state collects taxes on its own, and also gets a share from the Centre's tax collections at rates mandated by Central Finance Commissions from time to time.

The state's non-tax revenue is derived from user charges levied for public services, such as education, health and other administrative charges, and from the commercial operations of state owned enterprises (SOEs). Non-tax revenue receipts from the Centre are in the form of grants. The state cannot directly access foreign borrowings or grants except through the central government, or with its prior permission.

Under Article 293 of the Indian Constitution, state governments cannot borrow without the prior permission of the central government. The fiscal space afforded to state governments is consequently well-defined in theory, with the central government imposing a hard budget constraint. This means that their expenditure is constrained by their revenue receipts and such borrowings as the Centre may permit.

In practice, however, there are several avenues open to state governments to get around the hard budget constraint. State fiscal policy, therefore, consists of adjusting expenditure to resources likely to be available over the medium term, including those borrowing sources which do not fall within the purview of Article 293, such as small-saving receipts, state provident and insurance funds and other deposits in the public account. Since 23% of the state's debt comprises National Small Savings Fund (NSSF) liabilities, and another 32% is Public Account exposure, over half of the state's debt as of March 2007 was outside the purview of Article 293.

In recent times, states have been taking increasing recourse to what can be termed as 'indirect' government expenditure. There is a realisation that the Government need not spend taxpayer revenues to assure outcomes like infrastructure and social investment. Such outcomes could be assured through various kinds of 'public private partnerships,' (PPPs) where the government's role is limited to giving tax breaks, permitting user charges, filling in financing gaps to assure market linked rates of return, and furnishing sovereign guarantees for raising low-cost borrowings. The central government also encourages and facilitates such PPPs through the viability-gap funding window by which central assistance can be given to fill up to 20% of the viability gap in infrastructure projects.

While such forms of sovereign spending are certainly innovative against the backdrop of fiscal stress, they nonetheless have a fiscal impact. Tax breaks and user charges for loan repayments are revenues foregone by government, and can be deemed to have been spent on such projects. Sovereign guarantees, on the other hand, are off-balance sheet contingent liabilities that could translate into budgetary outflows in the event of managerial failure or revenue shortfalls over the repayment period.

Revenue

Table 1 gives the contribution of the three main sources of the state's revenues from 1990-91. Two things are immediately apparent. First, the share of central transfers, consisting of the state's share of central taxes and grants (both Plan and Non-Plan) in the state's revenues has declined slightly from around 35% to 30% at present. Second, while the state's own revenue mobilisation has risen from around 65% to 70%, the share of non-tax revenue has declined sharply from about 8-10% to 6%. This has been more than fully compensated by the increase in the share of the state's own tax mobilisation whose share in total revenues has increased from a

little over 55% to about two-thirds at present. About three-fourths of the state's own tax revenue comes from the Value-Added Tax.

Table 1: Revenue Mobilization

Year	Own Tax Revenue (%)	Non-Tax revenue (%)	Central transfers (%)
90-91	56	9	36
91-92	59	8	33
92-93	57	8	35
93-94	54	9	36
94-95	60	8	32
95-96	62	10	28
96-97	63	8	28
97-98	63	8	29
98-99	65	8	28
99-00	65	7	28
00-01	67	8	25
01-02	65	6	29
02-03	69	6	25
03-04	68	7	25
04-05	66	6	28
05-06	64	6	30
06-07	66	5	29
07-08	65	6	29

On the resources side, the state government has a free hand in the levy of user charges, but flexibility in fixing tax rates has been severely restricted with the introduction of Value-Added Tax (VAT) in lieu of state sales tax, the major source of state tax revenue. There are, nevertheless, some taxes on which the state continues to have full control, especially state excise, registration, motor vehicles and property taxes, though given the general drift of tax reform, it is likely that some of these rates may also be nationally unified in the near future. Be it as it may, the state's flexibility in setting tax rates is limited to a narrowing band. Irrational or excessive rates are distorting, subject to the logic of the 'Laffer Curve' and make for low-tax buoyancy. Besides, the possibility of labour and investments migrating elsewhere are increasing in proportion to the openness of the economy and globalisation.

Kerala is a major consuming state. The growing discrepancy between income data, captured in national accounts calculated by the Central Statistical Organisation, and consumption data, gathered by the National Sample Survey Organisation, is well-known. While the overwhelming national pattern is to understate consumption relative to income, Kerala is rather unique in that consumption estimates exceed income estimates. Thus, while Kerala's per-capita income is not appreciably higher than the national average, it has one of the highest per-capita consumption expenditures in the country. This is because of large remittances sent by Keraites working outside the state, variously estimated to inject an amount equivalent to between 15% and 20% of the state income into the economy each year. Since this additional income, which does not form a part of the state's gross domestic product, is captured in the state's revenue by way of taxes on consumption, the state has the potential to sustain relatively high (own) tax buoyancies even in years of relatively low growth. Its tax collections till recently were, however, quite volatile, possibly on account of high, discretionary and cascading tax rates that made for poor tax compliance. Following the switchover to the VAT system, the state's own tax buoyancy has risen sharply after the one-time downward adjustment in the introductory year 2005-06 as Table 2 would show, and may now be expected to stabilise.

Table 2: Own Tax Buoyancy

Year	GSDP Mkt Gr (%)	OTB (%)
1995-96	21.6	97
1996-97	14.7	104
1997-98	11.3	137
1998-99	13.6	24
1999-00	11.3	104
2000-01	11.6	112
2001-02	3.7	24
2002-03	12.1	192
2003-04	10.2	97
2004-05	12.4	94
2005-06	11.0	83
2006-07	18.9	117
2007-08	11.9	124

GSDP (Mkt Gr) - Growth rate of GSDP at Market Prices
OTB - Own Tax Buoyancy

The corollary of the disconnect between per-capita state income and consumption is that while the ratio of Kerala's own tax revenue to GSDP is comparable with those of neighbouring peninsular states, when considered as a proportion of total consumption, Kerala's tax collections are significantly lower. It is, therefore, quite likely that the movement towards more rational and unified rates, and especially the introduction of a unified goods and services' tax (GST), would in the long-run inject greater buoyancy into the state's revenues, as indeed appears to be happening.

Table 3: Tax Burden in Rupees Per Capita 2005-06

State	GSDP Mkt ^{**}	OTR ^{**}	Consumption ^{**}	OTR/Cons (%)	OTR/GSDP (%)
Andhra Pradesh	29244	2380	10437	23	8.1
Gujarat	39406	2855	10185	28	7.2
Karnataka	30350	3312	9373	35	10.9
Kerala	35773	2940	14251	21	8.2
Maharashtra	41259	3200	11822	27	7.8
Tamil Nadu	34318	3581	11137	32	10.4

* RBI State Finance 2007-08

** NSSO 62 Round

OTR: Own Tax Revenue

A characteristic feature of Kerala's public finances is the very low non-tax revenue realisation. Its own non-tax revenue, at 0.8% of the GSDP, is the second lowest amongst major Indian states, and only slightly higher than West Bengal (0.5%).² There is, consequently, a great unrealised fiscal potential here, but there appears to be an unstated political consensus in the state to keep charges for public service deliveries low and below cost, and to rely more on tax revenues. This is likely to limit severely the ability of the state to access substantial central assistance

¹ About 75% of the state income is from the tertiary and construction sectors, the growth drivers of the economy whose share in the State income is rising sharply. This share increased sharply by 9 percentage points in just seven years from 1999-2000

² Average for the financial years 2003-04 to 2005-06

and/or market funding for 'public-private partnerships' which rely on revenue flows from user charges to service investment.

Expenditure

The rigidities on the expenditure side are daunting, with expenditures on salary, pensions and interest (SPI) on state debt rising sharply and continuously over the last several years. Sharp increases in SPI expenditures have had the effect of overestimating resources at the budget formulation stage to protect Plan outlays. The resultant shortfall in resource mobilisation has in effect meant that SPI expenditures have crowded out Plan expenditure, which has fallen well short of outlays year after year.

SPI expenditures currently exceed the state's own revenue mobilisation, and are equivalent to about 82% of total revenue, including central devolutions.

The most explosive growth has been in pensions, which have grown at a compound annual growth rate of 17.5% since 1987-88, significantly higher than the growth of both state income and revenue. (Table 4) The state is not far from the point where annual pension payouts would be higher than salary payments of serving state employees. Firstly, the retirement age of 55 years applicable to state government employees is the lowest in the country, while life expectancy is the highest. Pension payments, therefore, continue longer in Kerala than in any other state, putting greater pressure on public finances. Secondly, the age of entry into public service has been rising over the last several years. Therefore, there is likely to be a sharp increase in the number of retirees who receive pension for a longer duration than their (productive) salaried life. If salary and pension liabilities continue to grow at the same rate as during the last 20 years, pension payments will exceed salary payments by the year 2021.

Table 4: SPI Expenditure

Rs. Cr.	1987-88	2007-08	% of Rev.	2007-08	% of CAGR*
Salary	805	8371	51	40	12.4
Pension	183	4592	12	22	17.5
Interest	213	4330	13	21	16.3
SPI	1201	17292	76	82	14.3
Revenue	1586	21106			13.8
Debt	2974	56056	188	266	15.8
GSDP	11199	148485	706	704	13.8

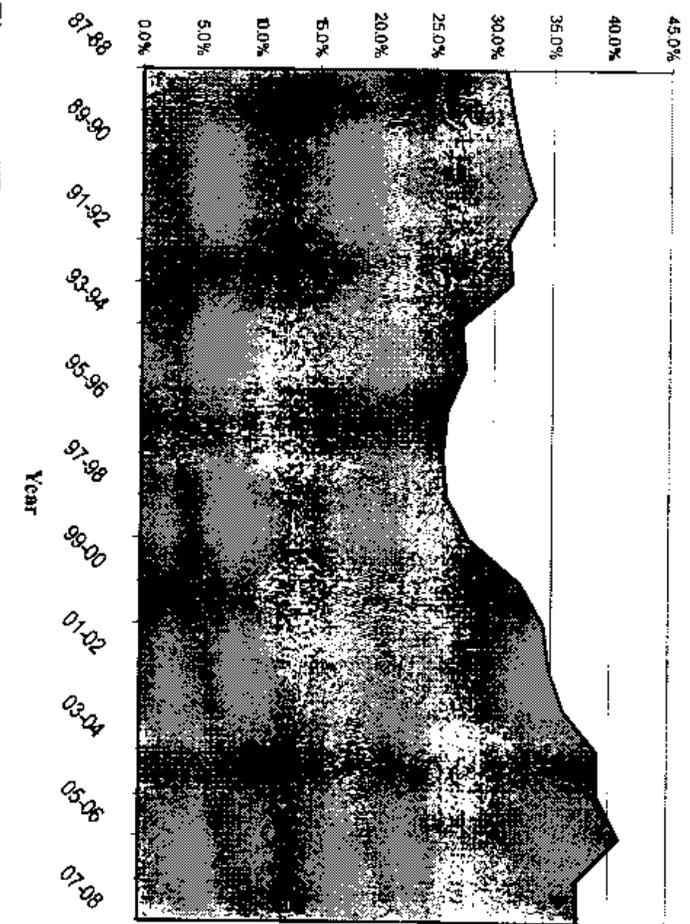
* Compound Annual Growth Rate

Since salary and pensions constitute a big chunk of total expenditure (44% in 2007-08), a characteristic feature of the state's public finances is the imprint left by five yearly pay revisions of public-sector employees. Such revisions generally take place every 10 years in most states and in the central government. As a result, there are five yearly spikes in the fiscal deficit as a proportion of the state income, following which the deficits begin to decline slowly, with debt ratios tending to rise first and then stabilise at increasingly higher levels. (Chart 1)

This cycle, reminiscent of an ascending sine curve, is set to repeat itself with the implementation of the latest Pay Commission award over two years in 2006-08. Improved revenue buoyancy and the impressive fiscal correction of the last few years are, however, likely to moderate the impact of the latest Pay Commission award. It should, therefore, be possible to stabilise debt levels with prudent fiscal management.

While Plan expenditure over the years has been consistently well short of Plan outlays, it has, nevertheless, tended to be lower than the fiscal deficit. This shows that the state has also been borrowing to finance a part of its non-Plan revenue expenditure, and that all marginal state expenditure, capital or revenue, plan or non-plan, is debt funded. SPI expenditures have crowded out social sector, capital and Plan expenditures over the years. Social services expenditure declined steeply from an average of 66.2% of revenue expenditure in 1990-91 to 46.7% in 2007-08. Measured as a percentage of the GSDP, it has declined from 11.3% to 7.5%. If this rollback in public outlays on social service expenditures has not been accompanied by a corresponding decline in social indicators, this is probably on account of the cushion provided by private overseas remittances that have sustained the 'Kerala Model' of development.

Chart I: Debt/GSDP Ratio



The fall in public infrastructural investment, however, has not been substituted in a similar manner. There has been a secular decline in capital expenditure, from an average of 1.8% of the GSDP in 1985-90 to 0.7% in 2003-08, leading to an increase in the revenue deficit component of the fiscal deficit. The revenue deficit is, however, slightly overstated. A peculiarity of expenditure accounting in the state is that use of capital receipts, including market borrowings, for generating productive assets in the strict definition of "assets of the state" is classified as revenue expenditure. Though nearly 30% of the annual Plan outlay – reclassified from 2006-07 as Non-Plan expenditure – is devolved to local bodies, this is shown as revenue grant in tune with the accounting standards of the C&AG. The assets created by the local bodies using devolved funds do not get accounted as capital expenditure. Much of the state's own expenditure on maintenance actually goes towards creation of new assets such as roads and bridges. Such accounting practices understate capital expenditure and have ensured that revenue expenditure accounts for about 80% of the

Fiscal Deficit. The Kerala Public Expenditure Review Committee, in its Second Report dated November 2006, has estimated that the revenue deficit was overstated by 1.1% of the GSDP in 2005-06. What this means is that while the state is on target to meet the XII Finance Commission's fiscal deficit target of 3% of GSDP by March 2009, it would be much harder to meet the 0% revenue deficit target.

Funding the Fiscal Deficit

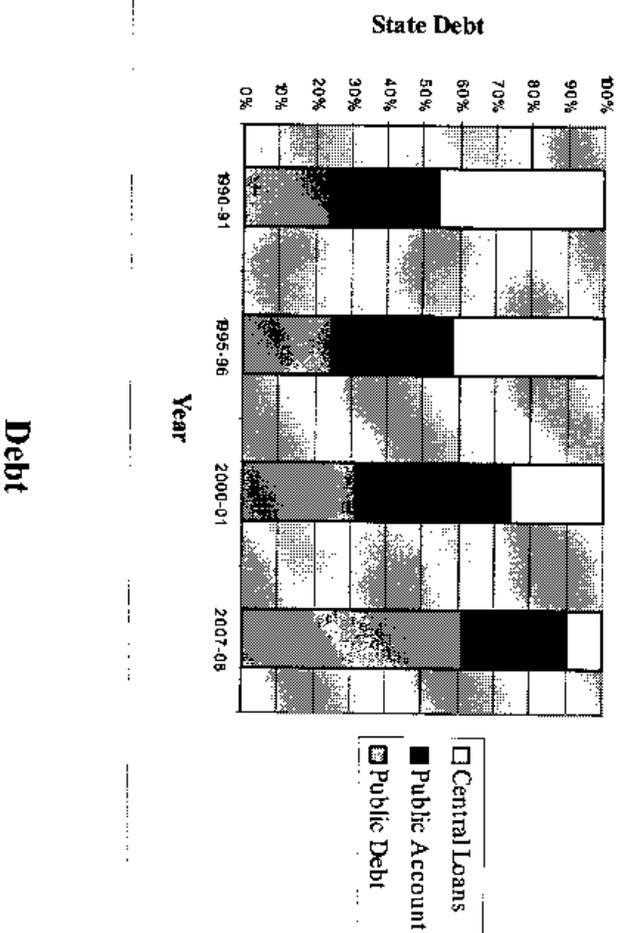
The fiscal deficit is the gap between the revenue and expenditure each year, which is equal to the net increase in the state's debt. Chart II shows that the structure of the state's debt, and therefore the funding of the fiscal deficit, has undergone a dramatic shift over the last 15 years. While the public account's share has remained virtually unchanged at about 30% (despite ballooning briefly during the fiscal crisis towards the end of the nineties), the share of central loans has fallen sharply from 46% in 1990-91 to 11% in 2006-07. This has been accompanied by a shift to public debt, including market borrowings and high-cost small savings, whose share has risen from 24% to 60%.³ Fresh central loans have been done away with altogether following the recommendations of the XII Finance Commission. The states now access the loan portion of central assistance through open market borrowings. The long-term implications of this shift are monumental, for the state of public finances would determine the cost of borrowing in the foreseeable future.

There are also "other" non-interest-bearing deposits with Government that also finance the fiscal deficit, but are not accounted as part of the state debt. "Others" have remained a fairly constant proportion of the state debt at approximately 5%. In addition, the state incurs unfunded off-balance sheet/budget liabilities in the form of unpaid bills and state guarantees extended for borrowing by governmental and quasi-governmental institutions, including special-purpose vehicles. Off-balance-sheet contingent liabilities rose sharply towards the end of the Nineties and early

³ Table 5 will show that the cost of borrowing has declined during the last few years. This is primarily on account of debt consolidation under which the interest rate on old central loans has been consolidated and lowered consequent on the State Government putting fiscal responsibility legislation in place. If receipts from the National Small Savings Development Fund and state treasury deposits, which are relatively high cost, continue to decline, the cost of borrowing can be expected to decline in future also. However, a rise in borrowing costs is also possible if the State government is tempted to plug resource gaps by hiking interest rates on (public account) treasury deposits.

years of the current decade till a legislative ceiling of 14,000 crore was set on state guarantees.

Chart II: Composition of State Debt



The lagged impact of running large fiscal deficits continuously over the last two decades is the huge debt overhang and growing interest payments. (Chart III)

How sustainable is this debt? Table 4 would show that the compound annual growth rate of debt, and interest payments thereon, have been growing much faster than both revenue and GSDP over the last two decades. The issue was highlighted in the state government's Medium-Term Fiscal Policy and Strategy Statement which forms a part of the 2006-07 State Budget documents: "A question that is often asked is whether the state's debt is too high, and whether it is sustainable. The Government of India classifies those states whose Debt to Revenue receipts ratio is over 300, and interest to Revenue Receipts ratio above 20%, as debt-stressed. Kerala's ratios are currently above this threshold, and hence the debt burden is unquestionably high. These, however, are prudential levels and should not be interpreted to mean that the state is insolvent or that the current debt burden is unsustainable. According to the Donnar Debt

liability equation, governments are solvent as long as the interest paid on debt is less than the GDP growth rate, provided the primary balance is positive or nominally negative. While it is true that the 'Donnar Gap' has been declining, and the primary deficit widening since the mid-Nineties, the gap has still not turned negative on average, and is now beginning to widen. This, as well as the fact that several other states have worse debt ratios, is small consolation, however, for five-yearly Donnar Gap averages are still marginally above zero, while the primary deficit also continues to be high."

Chart III: Fiscal Deficit and Debt Stock

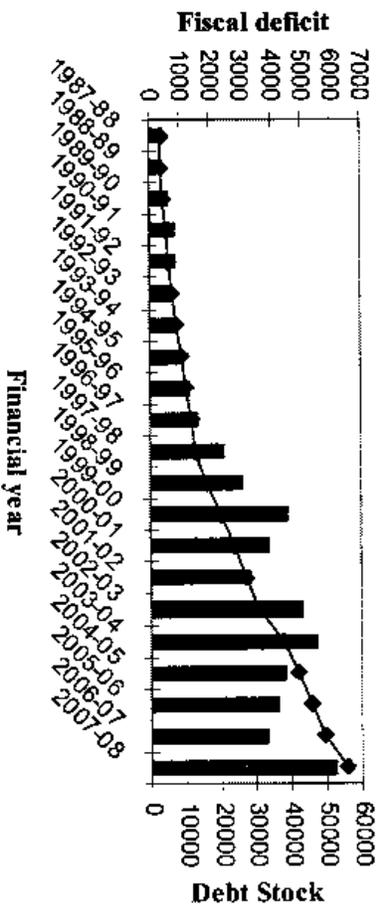


Table 4 will show that the debt/revenue receipts ratio has now fallen well below 300%, though Chart I indicates that the debt/GSDP ratio is still well above the central government threshold of 20%. Table 5 will show that the 3-year moving average Donnar Gap was negative over the three years ending 31 March 2004. The gap has since increased smartly and is now 5.8%.

Since state income figures are putatively unreliable, the sustainability of the state's debt can be crosschecked by using revenue receipts as a proxy for the GSDP, since this directly captures the state's debt repayment capacity. The Donnar Gap calculated on the basis of revenue receipt growth rates shows that while this was worse than the GSDP based gap in the past (since revenue buoyancy was poor), current figures show dramatic improvement, with the 3-year moving average currently at 8%.

The average Domar Gap over the last three years ending 2007-08, calculated by either the GSDP or the revenue receipt criteria, is within a comfort zone of 6-8%, while the primary account is only nominally negative. The Domar-equation conditions of debt sustainability are, therefore, met.

Liquidity Management

Solvency and liquidity are not the same. While insolvency would sooner or later lead to a liquidity crisis, it is also possible for a solvent state to suffer from liquidity problems on account of poor day-to-day treasury management. When the state treasury is out of pocket at any point of time, it falls back on overdraft from the Reserve Bank of India. When the state Government's account slips into deficit, the Reserve Bank automatically extends a ways and means advance (WMA) up to a certain limit. When the WMA limit is breached, the state slips into overdraft, which must be liquidated within 5 to 14 days, depending on the extent of the overdraft, otherwise the State Treasury would close down.

The Kerala government has a poor record of overdraft and liquidity management when compared to other state governments in recent years, as Table 6 would show. Most states are presently sitting on huge treasury bills and balances. The poor liquidity of state finances not only results in carryover of unpaid off-balance sheet liabilities but expectations of deferred payments are also discounted by contractors to quote higher rates for government works and supplies.

Table 5: Domar Gap Measure of Debt Sustainability

Date	31.3.99	31.3.00	31.3.01	31.3.02	31.3.03	31.3.04	31.3.05	31.3.06	31.3.07	31.3.08
GFD/GSDP	-5.4%	-6.7%	-5.4%	-4.3%	-5.9%	-5.7%	-4.2%	-3.8%	-2.9%	-4.11%
Debt	15700	20176	23919	26951	31060	37452	41878	45929	49872	56056
Growth	22.0%	28.5%	18.6%	12.7%	15.2%	20.6%	11.8%	9.7%	8.6%	12.4%
Revenues	7198	7942	8731	9056	10634	11815	13501	15295	18187	21106
Growth	1.1%	10.3%	9.9%	3.7%	17.4%	11.1%	14.3%	13.3%	18.9%	16.1%
GSDP (current prices)	56204	62529	69792	72402	81146	89461	100531	111633	132739	148485
Growth	13.6%	11.3%	11.6%	3.7%	12.1%	10.2%	12.4%	11.0%	18.9%	11.9%
Interest	1446	1952	2258	2489	2947	3328	3613	3799	4190	4330
Interest/Debt	9.2%	9.7%	9.4%	9.2%	9.5%	8.9%	8.6%	8.3%	8.4%	7.7%
WPI Inflation	5.9%	3.3%	7.2%	3.6%	3.4%	5.5%	6.5%	4.4%	5.4%	4.6%
Real borrowing cost	3.3%	6.4%	2.3%	5.6%	6.1%	3.4%	2.1%	3.8%	3.0%	3.2%
3YrMA*			4.0%	4.8%	4.7%	5.0%	3.9%	3.1%	3.0%	3.3%
Domar Gap (GSDP)	4.4%	1.6%	2.2%	-5.5%	2.6%	1.4%	3.7%	2.8%	10.5%	4.1%
3YrMA*			2.7%	-0.6%	-0.2%	-0.5%	2.6%	2.6%	5.7%	5.8%
Domar Gap (Rev.)	-8.1%	0.7%	0.5%	-5.5%	7.9%	2.2%	5.6%	5.0%	10.5%	8.3%
3YrMA			-2.3%	-1.5%	1.0%	1.5%	5.3%	4.3%	7.1%	8.0%
PD/GSDP 3YrMA	-1.2%	-2.4%	-2.7%	-2.2%	-1.7%	-1.4%	-1.3%	-0.7%	-0.3%	-0.4%

* Five-Year Moving Average

GFD: Gross Fiscal Deficit

PD: Primary Deficit

Table 6: Liquidity Management

Year	No. of Days	
	WMA	Overdraft
1992-93	101	64
1993-94	95	13
1994-95	26	2
1995-96	0	0
1996-97	5	2
1997-98	41	0
1998-99	173	33
1999-00	201	85
2000-01	126	213
2001-02	136	222
2002-03	161	196
2003-04	155	177
2004-05	191	161
2005-06	240	63
2006-07	223	63
2007-08*	155	40

WMA – Ways and Means Advance

* Up to Nov. 30, 2007

It is difficult to pinpoint reasons for Kerala's poor record in fiscal targeting and liquidity management. The biggest culprit, no doubt, is the general tendency to overestimate resources in the Budget, but this is probably true of most other states as well to some extent or the other.

There are possibly four factors specific to Kerala that contribute towards poor fiscal targeting:

First, the state has a long history of greater reliance on the public account. This was mainly on account of the fact that the treasury of the erstwhile state of Travancore conducted banking operations, accepting interest-bearing deposits from the public. These banking functions continue, with about one-third of the state debt, including the state provident fund, in the public account. The public account is highly volatile since it is virtually impossible to predict the quantum or timing of fresh deposits and withdrawals.

Second, there is a tendency to incorporate a significant amount of unbudgeted expenditures through supplementary demands for grants

(SDGs) during the course of the year, without showing matching savings or equivalent additional resource mobilisation.

Third, the management of government expenditure is made more difficult because the State Plan, which usually accounts for about a quarter of total government expenditure, has very limited fungibility between funding sources. About 75% of Plan resources are for specified items of expenditure such as externally aided projects, NABARD-funded schemes, centrally sponsored schemes, XII Finance Commission-earmarked expenditure, and by local bodies. Any mismatch between actual expenditures and sources of funding tends to create a liquidity problem.

Fourth, the liquidity problem is compounded by the fact that some 25% of all Plan expenditure (externally aided projects, NABARD projects and centrally sponsored schemes) is on re-imbursement basis for which the state government has to first incur expenditure from its own resources. Additionally, about 30% of Plan funds are transferred to local bodies, and, therefore, pass out of the scope of the State Finance Department's liquidity control system. The net result is that the state government's liquidity is not commensurate with the overall deficit as expenditure is usually below budgeted levels.

Current fiscal Trends

Table 5 indicates that there has been a continuous improvement of fiscal parameters over the last four years ending March 2007. The fiscal deficit declined from 5.9% of the Gross State Domestic Product (GSDP) in 2002-03 to 2.9% in 2006-07, bringing it within the target of 3% set by the Twelfth (Central) Finance Commission⁴. Consequently, the Debt/GSDP and Debt/Revenue ratios have been falling sharply in recent years. The fiscal parameters of Kerala nevertheless remain the worst amongst the major peninsular states as Table 7 indicates.

⁴ The slippage to 4.1% in 2007-08 is on account of the spillover of liabilities arising out of the implementation of the latest Pay Commission award in 2006-07. However, with VAT revenues showing good buoyancy it should not be difficult for the state to reach the fiscal deficit target of 3% in 2008-09.

Table 7: Fiscal Parameters of Peninsular States

	Average 2003/04 to 2005/06		2005-06		
	GFD/GSDP	Debt/GSDP	Debt per capita	Domar GSDP (%)	Domar Rev (%)
AP	3.9	43.3	12783	5.4	14.4
Gujarat	4.4	38.5	15101	9.0	16.3
Karnataka	2.7	29.9	8814	7.4	6.6
Kerala	4.7	42.3	14394	3.2	5.3
Maharashtra	4.8	33.3	13953	7.7	11.7
Tamil Nadu	2.4	30.2	9802	4.2	12.2

It is often argued that fiscal policy should strive to be counter-cyclical: expansionary in times of low growth to inject demand, and contractionary in times of boom to make necessary fiscal corrections. Whether by design, or the hard budget constraint enforced by the central government, or on account of the convergence with the Pay Commission cycle, the state's fiscal pattern over the last few years has tended to be counter-cyclical in that fiscal deficit reductions have coincided with a phase of high growth.

The last two decades has seen a gradual rollback of the state. Public expenditure, and especially investment, as a proportion of state income has shown a declining trend over the last two decades. In the period 1997-2000, this was accompanied by a decline in growth. However, during the period 2005-08, while public expenditure and investment continued to decline, growth accelerated. The anomaly of public investment and expenditure and state growth rates moving in diametrically opposite directions indicates that private investment has more than made up for the decline, as would be apparent from Table 8. The role of public sector demand as a driver of growth has diminished significantly.

Table 8: Public Expenditure and Growth

	3 Year Averages		
	1987-90 (%)	1997-00 (%)	2005-08 (%)
Total Expenditure/GSDP mkt	20.7	18.4	17.1
Capex/Total Expenditure	8.6	6.7	4.7
GSDP real Growth rate	6.8	5.8	7.8

Looking Ahead

Kerala's public finances have shown an impressive improvement over the last few years despite having to absorb the fiscal shock of the latest Pay Commission in 2006-07. The hiccup in 2007-08 is mostly on account of rollover of some lump-sum liabilities arising out of the Pay Commission. If revenues continue to show the buoyancy shown in recent years, fiscal improvement may continue, and the XII Finance Commission fiscal deficit target may be achieved by the target date of March 2009. The revenue deficit target of 3% of the GSDP is, however, unattainable under current accounting rules. The biggest long-term domestic threat to the state's public finances is undoubtedly the exploding pension liabilities. This issue would need to be addressed, sooner rather than later.

Kerala has been a major beneficiary of globalisation since exports of labour, plantation crops and marine products and tourism inject substantial income into its economy. This outward orientation by its very nature can also be potentially destabilising and volatile. Perhaps the biggest contingent threat to public finances is external shock, particularly emanating from the volatile Middle East that could see a sharp downturn in external remittances and ipso facto in state revenue and the ability of the state to sustain the Kerala Model of development.

The greater threat to the Kerala Model, however, may well be a long-term and structural one, as there are clearly demographic limits to sustaining the remittance economy. Kerala is not only graying ahead of the rest of the country but has also long had a practice of young people migrating out to seek employment, and returning home as retirees. This is hastening the process of demographic transition and inverting the age pyramid. A declining workforce would mean that, over the long run, the tradeoffs between migration-based income expansion and domestic employment opportunities may be more limited.

The recent improvement in public finance indicators was achieved in a benign macro-economic environment of high growth, low inflation and declining interest rates. The average annual growth rate of the Indian economy over the X Plan period is estimated to be 7.6%. Kerala's growth is estimated to be slightly higher at 8%. This benign macro-economic environment is currently threatened by potentially stagflationary conditions combining declining growth with rising inflationary expectations. Monetary tightening by the Reserve Bank of India can put pressure on state finances by raising the cost of government borrowing since state governments have been increasingly pushed to the open-market borrowing route to fund their deficits. An uncertain external outlook can put pressure

on the rupee and reduce remittances, which could have an adverse impact on the state's revenues.

Sustained high growth rates over the last five years has meant that average per-capita income in the state has almost doubled since the year 2000 in real terms. This does not take into account the consumption effects of foreign remittances, which are estimated to inject the equivalent of 15%-20% of the state income into the state economy each year, as a consequence of which Kerala has one of the highest per-capita expenditures amongst Indian states. External remittances are, however, double-edged. On the one hand, they provide a valuable cushion against unemployment, falling commodity prices and decline in the state's social sector expenditures. On the other hand, they also create symptoms of the 'Dutch Disease' through wage inflation, lower investment and depress domestic savings by creating an illusion of household as well as public financial stability that could be easily destabilised in a worsening external environment.

The benefits of growth have been passed on unequally to different sections of society, as is frequently the case in the early stages of rapid economic development as the workforce shifts from agriculture to the more productive secondary, and especially tertiary sectors, as postulated in the Kuznet's curve. During the last five years, between 2001-02 and 2006-07, agriculture accounted for just 11% increase in the state income, the secondary sector accounted for 28%, while the tertiary sector accounted for a whopping 61%. Since the state is not a major manufacturing hub, the tertiary sector and overseas migration has taken on part of its function in creating more productive jobs.

Though the state economy has been growing at 8% in real terms, the income of the agricultural and allied sectors has remained virtually constant even in nominal terms. Consequently, the primary sector's productivity has stagnated or declined, and its share in the state income has fallen sharply from about 20% to 15% in the last five years. This fall is much steeper than the national trend. The agricultural crisis in the state has been magnified on account of its greater reliance on commodities, such as tea, coffee, rubber, cashew, spices and coconut, which now occupy close to 90% of the gross cropped area. Commodity prices, though generally much higher, are notoriously volatile compared to food crops. This is perhaps the main reason for chronic indebtedness and suicides amongst farmers who are dependent on such commodities, be it cotton in Vidarbha, or pepper and coffee in Kerala. The 'Vidarbha Package' has been extended to the districts of Wayanad, Palghat and Kasargod, and the state government passed an Agricultural Debt Relief Commission Act in

December 2006. However, a durable strategy to address the underlying price volatility leading to persistent indebtedness has still to emerge. The rollback of social-sector expenditures may have magnified the crisis by pressuring marginalised groups who perforce fall back on public-sector service delivery. The crisis in the agricultural and traditional sectors would no doubt exert fiscal pressure and reprioritising of public expenditures in the near future.

On the upside, it is quite likely that after initial teething troubles, the introduction of VAT would improve and stabilise the state's own tax buoyancy. The movement towards a unified goods and services tax could dramatically improve state finances given the structure of the state's economy as a major hub for final consumption. A financially healthy power utility, and a reasonably good infrastructure by national standards, means less long-term pressure on the fiscal, though the state would need to continue adjusting its expenditure pattern to reduce its accumulated long-term liabilities and also to make room for the upkeep and modernisation of the infrastructure already in place. Major infrastructural projects such as world-class seaports, airports and roads would also need to be funded through a combination of tax revenues and 'public-private partnerships'.

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CHAPTER THREE

RESOURCE MOBILISATION IN INDIA --

SOME ISSUES

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Shortage of financial resources to implement Plan programmes is one of the important problems facing the government. In this paper, an attempt is made to examine various components of resource mobilisation of the Central Government in India. The emphasis will be on studying the issues involved in a resource mobilisation policy rather than evaluating the magnitude of the problem through quantification. To be specific, in what follows we examine the policy issues involved in relation to the following items: Personal Income Tax, Agricultural Income Tax, Corporation Tax, Excise Duty, Customs Duty, Public Borrowings and Administered Prices and Subsidies.

Personal Income Tax

- Richard Goode has identified a list of conditions which are to be met in a country if income tax is to emerge as a major source of revenue. The list of conditions identified by Richard Goode includes the following:
- The existence of a predominantly money economy,
 - A high standard of literacy.
 - Prevalence of honest and reliable accounting,
 - A large degree of voluntary compliance on the part of tax payers.
 - A political system not dominated by wealthy groups acting in their self-interest.
 - Honest, reasonably efficient administration.

It can be seen that the conditions identified by Richard Goode are not satisfactorily met in India and, consequently, the share of revenue from income tax remains low in the country. However, an attempt is being made in the country to increase the share of income tax in total tax revenue. In