Sub-national Fiscal Sustainability in a Globalised Setting

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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 that 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 form 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 form 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.

CHAPTER ONE

SUB-NATIONAL FISCAL SUSTAINABILITY IN INDIA WITH SPECIAL REFERENCE TO KERALA

N.J. KURIAN AND JACOB JOHN

Since the inception of the fiscal federal structure through the Mayo Resolution of 1870, India had a financially sound centre/imperial government and financially dependent states/provinces. For a brief period in the 1920s, however, a system of 'inverted grants' from the provinces to the imperial government was in practice due to deficit with the centre and surplus with provinces arising out of the Government of India Act, 1919. The Government of India Act, 1935, restored the fiscal superiority of the Federal Government.

The founding fathers of the Indian Constitution more or less adopted the provisions of the Government of India Act, 1935, as far as the fiscal relations between the union and states are concerned. The Seventh Schedule of the Constitution lists the different functions which are divided into union list, state list and concurrent list. Articles 268 to 274 of the Constitution provide the nature of distribution of revenues between the centre and states. On the whole, there was an imbalance between the expenditure responsibilities and the revenue-raising capacities between the union and states. Recognizing this asymmetry, the Constitution provided for devolution of a part of central tax revenues to the states as determined by the Finance Commission once in five years.

India is not an exception in having a fiscally strong centre and fiscally dependent states. In general, most of the federal nations have fiscally strong centre with provision for transfers to fiscally weak federating units. This is true of major federal countries like Australia, Brazil and Canada. Often, due to history, geography, demography and natural endowments, there will be significant differences among the sub-national governments in their ability to raise fiscal resources. At the same time, a general principle accepted across all federal nations is that all their citizens should receive more or less same standard of civic and other public services irrespective of their place of stay. To facilitate this, institutionalized federal fiscal transfers are mandated.

The planning process started in 1951 with the beginning of the First Five Year Plan, which enlarged the scope of the centre in increasing the financial domination over the states. During the first three Five Year Plans, the central financial assistance for state development plans was provided as project assistance linked to the ongoing projects in the states and new projects taken up by the centre located in the states. In this process, there was hardly any freedom / flexibility for the states to use the central funds for projects which are the priorities of the states. Before the beginning of the Fourth Five Year Plan, the state chief ministers jointly requested the centre to evolve a formula for devolution of plan assistance to the states without any linkage to projects. In response, a formula known as ‘Gadgil Formula’ – named after the-then deputy chairman of the Planning Commission, D.R.Gadgil – was evolved, which has been used for allocating central plan assistance to the states since the beginning of the Fourth Five Year Plan in 1969. During the first few years of its operation, more than 90% of the state plan assistance was devolved through this formula.

A substantial share of the central plan is devolved to the states for implementation of central and centrally sponsored schemes. While central plan schemes are based on the priorities of the centre and are normally falling in the domain of the centre in terms of the Constitutional division of powers, it is a different situation as far as the centrally sponsored schemes (CSS) are concerned. CSS acquired importance with the introduction of several new schemes, including family planning, various anti-poverty schemes and welfare schemes in the 1970s. Most of them are in the domain of the states or at best in the concurrent list of the Constitution. These schemes are mostly formulated by the centre with very little involvement of the states. The centre often imposes schemes on uniform pattern upon the states irrespective of the ground realities on the strength of its financial clout. States normally accept them to take advantage of the additional funds which came with such schemes.

After the Liberalization, Privatization and Globalization (LPG), the states have regained some of the lost economic policy making space. This, however, has been partly nullified by other factors which accompanied the economic reforms. For example, with LPG, private investment has become the principal engine of economic growth. The experience over the past 18 years indicates that private investments mainly flow to those states which are able to attract them with favourable conditions. During this period, half a dozen relatively developed states, which account for a little over one-third of the population of the country, attracted almost two-thirds of private investments which included private investment from both domestic and foreign sources. These states got the benefit of cheap migrant labour from the backward parts of the country. This has resulted in increasing disparities in the level of development among the states and different regions in the country.

The discussions so far clearly indicate that 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. One of the outcomes of LPG and associated fiscal discipline is state withdrawal from vital state functions like education, health care and other social services. The current financial arrangement and incentive system encourage unhealthy competition among the states. Since private investment has become the principal source of economic growth, those states which have initial advantages attract more investment and, therefore, achieve faster growth resulting in aggravating disparities among states. States which lack infrastructure and other favourable factors need to create them to attract private investments. But their fiscal constraints do not allow them to make investments in these vital sectors.

Central and state government finances came under great stress during the latter part of last decade and the situation continued in the early years of the current decade. This is on account of a variety of reasons. They include the slowdown of the economy following the east Asian financial crisis, massive salary and pension revision for central government employees followed by similar upward revision for state government employees, market-related interest charges for government loans as a part of financial sector reforms as compared to lower rates allowed before reforms resulting in increased interest burden of the governments and reduced tax-GDP ratios at the centre and states. A major reason for reduced tax revenues of the states was competitive tax reduction among the states to attract new industries. The centre’s tax-GDP ratio came down from 11% at the beginning of 1990s to below 9% a decade later. This has resulted in reduced tax devolutions and plan assistance to the states.

The five-year period since 2003-04, however, saw significant fiscal correction and consolidation at the central and state levels. The tax-GDP ratio of the centre increased from 8.8% in 2002-03 to 12.5% in 2007-08. In the case of states, the corresponding increase was from 5.7% to 6.5%. Another important factor which contributed to fiscal correction during this period was the Fiscal Responsibility and Budget Management (FRBM)

Act, 2003, of the centre and similar Acts of the states. FRBM Acts lay down a path for reduction of gross fiscal deficit (GFD) and revenue deficit (RD) with specific milestones to reach the destination by fixed dates. Thus, the centre was expected to reduce the GFD and RD to 3% and 0% of GDP, respectively, by March 2009. States were also expected to reduce their GFD and RD in relation to their respective Gross State Domestic Products (GSDP) to 3% and 0%. As a result of the FRBM targets, fiscal and revenue deficit compression appeared to be attainable at the centre as well as in the case of most states till recently.

This situation has undergone a sea-change over the last one year. The still-unfolding implications of the global financial and economic crisis on the union and state finances are going to be severe. Most of the major tax revenues of the centre and the states have been experiencing lower growth during the year on account of reduced production, consumption, trade and income. At the same time, government expenditures are being stepped up to fight recession. The stimulus packages, along with the substantial sum spent on pay revision by the central and state governments, have upset almost all the government budgets during the year. Neither the centre nor the states are likely to meet the FRBM targets of deficits reduction by March 2009. Indeed, it may take years before the targets set for the current year could be realized. Meanwhile, the concern of the central and state governments will be mainly to ensure that the downward slide of the real economy is arrested and the trend is reversed to put back the economy on a steady, high-growth path. A critical concern, however, is whether these objectives could be achieved within the boundaries of sustainable public finances at the national and sub national levels.

With the above background, the present Volume examines the sub-national fiscal sustainability of the Indian states in a globalized setting. The public finances of Kerala have been taken up for more detailed and incisive analysis. Kerala has the distinction of achieving 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.

Kerala is known for certain social, political and economic reforms which enabled the state to ensure a modicum of social and economic security to the poor and marginalized people in society. Its unique problems include high unemployment, increasing morbidity and declining quality of education. Kerala’s economy has been growing at a rate on par with, or higher than, the all-India average since 1987-88. Remittances from overseas Malayalees contribute about 22% of the state’s income. This has fuelled consumption, triggering the growth of the tertiary sector.

The state's governance model, driven by public investment in social sectors like education and health, and welfare schemes including a strong public distribution system, could fuel sustained economic growth. However, there is an urgent need for ensuring the sustainability of Kerala's remarkable social progress by continued public investment in social sectors. This requires significant improvement in the public finances of the state.

Kerala has a highly commercialized and monetized economy where more than 60% of its products are exported. Like many other states, Kerala has also been facing a new problem of skewed economic development in the globalized setting where all segments of society are unable to take part in the development process. Significant segment of society is neither able to participate in and contribute to the production process nor to receive any return from the development process. This problem is not restricted to Kerala; indeed, it is the case in all parts of the country. One of the main reasons for the defeat of the National Democratic Alliance (NDA) in the 2004 election was the neglect of this problem. Perhaps this problem is more acute now. The gains from high growth experienced during the recent years have been highly inequitably shared. This is evidenced from the fact that the rate of annual reduction in poverty has come down in recent years as compared to the earlier years when growth performance was less impressive.

A close look at the economy of Kerala clearly indicates that the financial position of the State has been steadily deteriorating during the past few years. Various reports prepared by different official agencies reveal that a financial crisis has been brewing for the past several years in Kerala. The political leadership in power in the state during various periods was blamed for the failure to evolve a policy that would put the economy on the right track of growth. It is a fact that though various governments took some measures to solve the problems that were threatening to precipitate the crisis, most of them are still persisting. Moreover, due to financial problems, Kerala is hardly capable of addressing the second-generation problems of human development. Budget deficit and public debt are often the outcomes of high levels of political mismanagement. Past experience of Kerala shows that the Left Democratic Front (LDF) and the United Democratic Front (UDF) have been coming to power after every five-year term alternatively and neither of them could get elected for consecutive terms. When they come to power, both the fronts blame each other for the financial crisis. It is an indisputable fact that the present LDF government, like the previous UDF government, has been facing serious financial difficulties.

Politically opportunistic spending undertaken by various governments, national as well as state, resulted in financial crisis. The objective of Fiscal Responsibility and Budget Management (FRBM) Act, 2003, of the Centre was to control such financial mismanagement by political leadership. Officially, the Act came into effect in July 2004. The FRBM mandates gradual elimination of government borrowing for any purpose other than public investment by 2009, and restrict the total amount of such borrowing per year to no more that 3% of GDP in three years. All the state governments are required to enact law in line with the central Act. Accordingly, the Kerala Fiscal Responsibility Act of 2003 was enacted. In the Kerala Fiscal Responsibility Act (KFRA), targets are fixed for reducing fiscal and revenue deficit. Under section 6 of the KFRA 2003, a Public Expenditure Review Committee was constituted and its first report was submitted in May 2006. Dr. Indira Rajaraman chaired the Committee, while Dr. N.J. Kurian and Dr. K.P. Kannan were the members. The Committee submitted its second and third reports in November 2006 and November 2007, respectively.

States like Kerala suffer from adverse implications of FRBM targets in view of long-term commitments to social-sector spending and periodic pay revisions. Going by the provisions of the FRBM Act, Kerala would have to sharply cut plan expenditures, reduce social spending and curtail devolution to local self-governments. The Planning Commission has already taken a position against the lack of flexibility in the FRBM Act provisions. Demands for flexibility are also fully endorsed by international experiences with fiscal responsibility legislations. As we have already discussed, the FRBM Acts have to be drastically amended or the target dates have to be postponed indefinitely in the context of the on-going financial and economic crisis.

The impact of the current global crisis is likely to be more severe on the economy and public finance of Kerala than on most of other Indian states. This is on account of the fact the economy of Kerala has much more exposure to the world economy than that of the rest of the country. Three areas of critical importance are (i) remittances from non-resident Keralites (NRKs) working abroad, (ii) tourist arrivals, and (iii) exports.

Out of about US$30 billion remittances received annually from non-resident Indians (NRIs), more than a quarter is from NRKs working abroad. Indeed, the remittances add more than 20% to the GSDP of the state. There are an estimated 2 million NRKs working in Middle-Eastern countries alone. The quantum of remittances is influenced by the economic conditions of the host countries, especially the countries in the Middle-East, the USA and the UK, the exchange rate of the Indian Rupee vis-à-vis the US dollar, the rate of interest on NRI deposits and the perception on the relative strength of Indian banks in the light of the global financial crisis. Till a few months ago, the countries of the Middle-East were booming on account of soaring oil prices. After the crash of oil prices, the situation has totally changed. Though on account of favourable conditions in India, the remittances continue to be high, the situation is likely to change drastically soon. It is anticipated that up to half a million NRKs working in the Gulf countries are likely to lose their jobs and return to Kerala in 2009. Apart from a steep fall in the remittances, this can create a major economic and social crisis in Kerala. Already, the government of Kerala has taken some steps to face the massive homecoming of NRKs.

Tourism is another area which is being hit hard by the global economic crisis. Kerala, characterized as 'God's Own Country' in tourism literature, has been attracting an increasing number of tourists from Europe and other developed countries over the last several years. Apart from generating sizable foreign exchange, tourism has been creating a large number of direct and indirect employment opportunities. During the past year, there was a considerable decrease in the number of foreign tourists visiting Kerala. The situation is unlikely to improve before the world economy turns around.

The exposure of Kerala's economy to foreign trade is much more than that of India as a whole. The principal exports from Kerala are spices, marine products and other processed agricultural products, and the main export destinations are the developed countries. The global fall in commodity prices and the recession in developed countries have serious adverse implications for the economy of Kerala.

There is an urgent need for revisiting the priorities of public finances of Kerala to ensure sustainable social and economic development of the state. This will have to result in considerable stepping up of the state's own tax and non-tax revenues and curbing of runaway revenue expenditure, especially on salaries and pensions. The state exchequer has to be relieved of the huge debt-servicing burden by eliminating borrowings to meet current expenditure. There is considerable scope for improving efficiency of public expenditure in the state especially in the various development departments.

Unlike most of the other states, Kerala had given 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.

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 Keralites 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