2. State Finances: An Overview

An Overview

Critical imbalances have emerged in the State's fiscal profile, the most disturbing being that of revenue deficit which has risen, as a percentage to Gross State Domestic Product (GSDP), from 0.99 in 1985–86 to 1.93 in 1996–97. Some key features of Kerala's State finances are summarised in table 2.1. The revenue deficit reached a peak of 2.99 in 1990–91, but has declined since. Kerala has the dubious distinction of being listed among those five States, which account for 85 percent of the aggregate revenue deficit of all States, the other four being Uttar Pradesh, Tamil Nadu, Andhra Pradesh and West Bengal (RBI, 1996–1997). Fiscal deficit has remained above 4 percent of GSDP in most of the years. In 1996-97, it was at 4.55 percent of GSDP. Primary deficit, as a percentage of GSDP, has been above 1.2. With fiscal deficit close to 5 percent of GSDP, the debt to GSDP has been steadily increasing. It has risen from 30.53 to 34.23 percent during 1991–92 to 1996–97. Both fiscal deficit to GSDP ratio and the debt to GSDP ratio are one of the highest among States. The revised estimates for 1997–98 and the budget estimates for 1998–99 indicate further worsening of both the fiscal deficit and the debt to GSDP ratios.

Table 2.1: State Finances of Kerala: An Overview

(Percent of GSDP)

	1985-86	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
Revenues	**18.23**	**17.04**	**16.27**	**16.65**	**17.42**	**17.29**	**18.05**	**18.42**
Own tax revenue	9.73	9.51	9.55	9.46	10.41	10.37	11.26	11.68
Own non-tax revenue	1.88	1.48	1.34	1.40	1.43	1.47	1.78	1.54
Central revenue transfers	6.62	6.06	5.38	5.78	5.57	5.45	5.01	5.19
Expenditure	**22.76**	**22.83**	**20.98**	**20.42**	**21.72**	**21.49**	**22.49**	**23.23**
Revenue expenditures of which	19.22	20.04	18.35	18.34	19.07	18.77	19.39	20.34
Interest payments	1.69	2.42	2.76	2.72	3.05	3.04	3.08	3.31
Pensions	1.37	2.08	1.93	1.87	2.06	2.09	2.39	2.26
Capital expenditure (net) of which	3.54	2.80	2.63	2.08	2.65	2.72	3.10	2.89
Capital outlay	2.74	1.82	1.63	1.39	1.61	1.65	1.88	1.87
Deficit and debt								
Revenue deficit	0.99	2.99	2.08	1.69	1.65	1.48	1.34	1.93
Fiscal deficit	4.29	5.66	4.87	3.42	4.15	4.27	4.30	4.55
Net borrowing[1]	8.15	5.24	4.20	3.75	4.83	6.05	4.30	3.92
Primary deficit	2.60	3.25	2.11	0.70	1.10	1.24	1.23	1.24
Outstanding debt	**30.84**	**32.74**	**30.53**	**30.59**	**31.92**	**32.68**	**33.66**	**34.23**

Source: CAG, relevant years.

Note: 1. Net borrowing reflects change in debt stock. Fiscal deficit is financed by net borrowing as well as ways and means advances, change in cash balance, net withdrawal from public accounts (other than small savings and PF) and contingency fund.

Government expenditure, net of repayments, has increased by less than one percentage point of GSDP between 1985–86 and 1996–97. In 1985–86 it amounted to 22.76 percent of GSDP. An overwhelming portion of this is revenue expenditure which has risen, as a percentage of GSDP from 19.22 to 20.34 between 1985–86 to 1996–97. On the other hand, capital outlay has been low and declining. In 1996–97, capital outlay was less than two percent of GSDP.

TAX REVENUES

Sales tax is the key source of tax revenue with a share of 71 percent in total own tax revenues in 1996–97, having risen from 63 percent in 1985–86. In order of revenue importance, stamp duties and registration fees, State excise duties and motor vehicles tax come next. Together these four sources accounted for nearly 97 percent of own tax revenues in 1996–97.

For these four major tax sources, the buoyancy of tax was more than 1 for the period 1991–92 to 1996–97. In each case, the buoyancy figure (table A2.1) shows an improvement over the corresponding value for the period 1985–86 to 1990–91. The overall buoyancy of tax revenues is 1.32 during 1991–92 to 1996–97 which compares favourably with other States. The three taxes where a decline in buoyancy is exhibited while comparing the 1991–92 to 1996–97 period with the late eighties are agricultural income tax, urban immovable property tax and the electricity duty. The last case shows increasingly negative buoyancies. The fall in electricity duty reflects non-payment of electricity duty by Kerala State Electricity Board (KSEB) even though it may have been collected from the consumers.

On the whole, the relatively healthy performance of tax revenues reflects the distinct feature of the Kerala economy of being dependent on remittances. While the buoyancies are calculated with respect to GSDP, several of the taxes including the sales tax rise because consumption has risen due to remittances. Further, due to the sharp depreciation of the Indian rupee in the early nineties, the rupee value of external remittances, increased sharply in the early nineties.

The highest percentage growth in sales tax revenue in any one year was 25 percent in 1991–92. On the whole, annual percentage change in sales tax revenue indicates considerable volatility. In the two years when the rupee depreciated to a very large extent, the growth rate in sales tax revenue was quite high. The actual collections in 1997–98 and 1998–99 are likely to fall short of the revised and the budgetary estimates, respectively. As per the latest information, sales tax revenue may grow only by about 12 percent in 1998–99, which is a matter of grave concern as it constitutes nearly 70 percent of own tax revenue. Excise tax collection was also highly volatile in the 1990s reaching a peak rate of growth of 49 percent in 1993–94. Stamp and registration also show fluctuations with a drastic fall in 1996–97.

Table 2.2: Annual Growth Rates of Selected Own Tax Revenues

(Percent)

	1986-87	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
Total sales tax	12.72	16.74	25.03	16.35	17.44	21.63	22.58	21.27
State excise	13.00	0.42	19.89	5.66	48.93	6.73	27.20	-6.85
Stamps and registration	17.64	7.91	24.75	24.59	21.39	28.52	19.60	1.84

Source: CAG, relevant years.

There is considerable scope for increasing the efficiency of tax administration in Kerala. In a comparison of sales tax administrative efficiency across the southern States, Sebastian (1996) has highlighted Kerala's relatively weak performance. In particular, test audits by the Accountant General indicate the highest incidence of revenue loss on average for Kerala during 1980–81 to 1992–93. These revenue losses have arisen primarily through irregular exemptions, incorrect application of rates and non-levy of penalty. Sales tax arrears in Kerala are the highest on average as compared to other southern States. As a percentage to total sales tax collections, arrears have risen to about 26 percent in Kerala whereas in Andhra Pradesh for example, this percentage was only 14.62 percent. Figures in the Sebastian study relate to the period 1980–81 to 1992–93.

There is an urgent need for computerisation of the sales tax administration. Revenue performance would increase with better information network. Checkposts need to be computerised through which almost 70 percent of the goods consumed in Kerala are brought in. Commodity-wise sales tax data should be made available and regular monitoring of information regarding inflow of goods through the checkposts will help improve the administrative efficiency of tax collection. Tax arrears, at Rs. 1100 crore, are also quite high. The Government of Kerala recently announced a scheme of interest waiver to encourage early payment of the outstanding dues.

Even though agriculture, especially plantation crops, constitute a significant portion of the State economy, the contribution of the agricultural income tax (AIT) has been low and volatile, often falling significantly. Successive enhancement of the exemption limit and some definitional changes (relating to measurement of area) have accounted for this poor performance. Price fluctuations relating to tea, rubber and cardamom largely account for the volatility exhibited by this tax source.

An important dimension of managing Kerala's taxes is to maintain parity/competitiveness with respect to the neighbouring States (Tamil Nadu, Karnataka, and Pondicherry). Pondicherry (a union territory) has an enclave called Mahe which is physically located in Kerala. For many commodities, the tax rates of Pondicherry are extremely low. As a result, people make purchases inside the UT. Furthermore, many dealers use this for straightforward tax evasion by selling the goods directly in Kerala but showing the bills as having originated in Mahe. The problem is especially acute for automobiles, refrigerators and Indian made foreign liquor (IMFL). This has led to considerable trade diversion and tax loss.

In order to get round this problem, Kerala has imposed an entry tax on certain specified items like furnace oil, high speed diesel, and computers, components and spares in the 1998–99 budget. Earlier, an entry tax was imposed on cement and iron and steel. It proved to be counter-productive for cement-based and steel-based industries in the State. The need for an entry tax has arisen because of diversion of trade and productive activities to the neighbouring States. Often, goods that are intended for sale within the State may be sent outside first and brought back as inter-State sales. The problems arising out of the extremely low tax rates of the Union Territory of Pondicherry should be solved through the intervention of the central government. In general, however, an entry tax and a cascading type of sales tax structure need not be encouraged. Barriers to trade and distortions caused by them are ultimately counter-productive for the industrial growth of the State. Rather, the State should move towards a tax system which is least distortionary and better aligned with the tax structures of the neighbouring States with a view to attracting and sustaining industrial activities within the State.

In chart 4, per capita sales tax revenues (table A2.2) for the four southern States of Andhra Pradesh, Karnataka, Kerala and Tamil Nadu are depicted. It will be observed that (i) sales tax per head is quite high for Kerala and Tamil Nadu; (ii) they have moved in tandem over time for these two States; and (iii) much faster than the other two States. While it is not advised that tax rates should be increased in general in Kerala, tax revenues would improve with better tax administration and collection of arrears.

The long term objective of the State should be to introduce Value Added Tax (VAT) so as to minimise tax-induced distortions in the manufacturing activities as also to widen the tax-base by capturing the value-added beyond first points of sale. In 1993, an attempt was made with respect to a selected list of commodities. In April 1997, VAT was withdrawn. By that time, it had covered 11 items. Many of them were high value items like washing machines, vacuum cleaners, refrigerators, airconditioners. Accounting problems faced by the dealers as well as the tax administration have been cited as the main causes for this reversal. A threshold limit for dealers was also not prescribed. As a result, a large number of dealers were covered from the very start. It seems that VAT was introduced in the State without adequate preparation. There was also an apprehension about revenue loss in relation to the concerned commodities. In particular, no attempt was made to first determine the revenue-neutral rates. In the context of several States now preparing for implementation of VAT, it is advisable for Kerala to make a second effort, but with adequate preparation. Since sales tax is the first point levy for many goods, and Kerala is a net importing State, it stands to gain by capturing the value added in the sales process within the State. Necessary pre-implementation stage steps are: (i) rationalisation of the rate structure, leading to a reduction in the number of tax rates to about 4 (at present, there are 18 rates); (ii) training of staff in the administration of VAT; (iii) computerisation of accounts of the tax offices and the big dealers; and (iv) dissemination of information to the dealers. Further, revenue-neutral rates need be worked out, and a strategy for implementation, beginning from a partial, and leading to a full, rebate of sales tax paid on inputs should be determined. Further, whereas a consignment tax is not being recommended with a view to having an unfragmented country-wide market, the State should press with the central government for a tax on selected services.

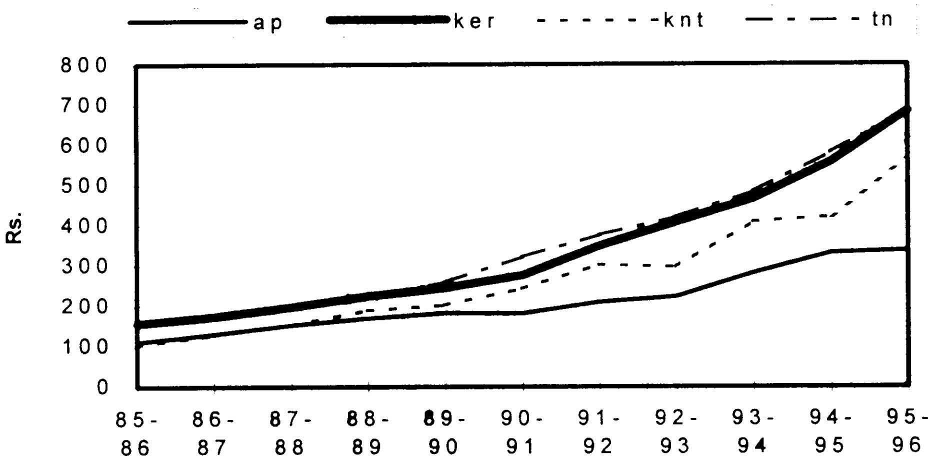


Chart 4 : Per Capita Sales Tax of Selected States

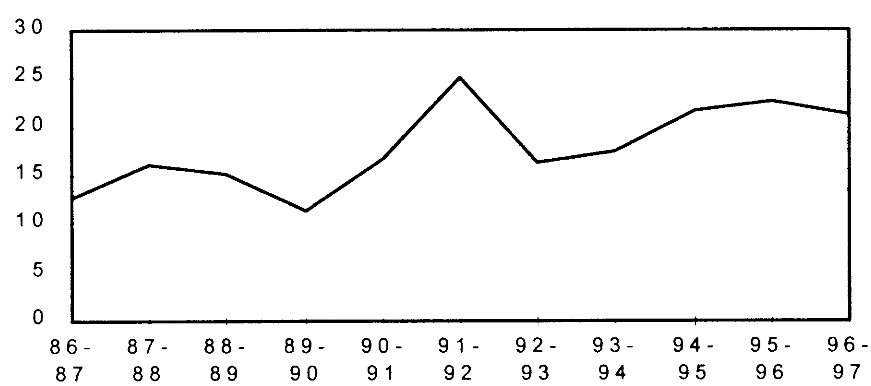


Chart 5 : Sales Tax Revenues : Annual Growth Rates

There is a long list of exempted items in the Sales tax Act (specified in schedule 3). This list should be reviewed and pruned. In particular, items like silk sarees and fabrics, can be taken off the list. Although, Kerala has an incentive scheme for new industrial units, this scheme has hardly been successful in attracting new industries. Rather, the same units keep re-establishing themselves every seven years, thereby causing substantial loss of revenue. The scheme has been necessitated primarily owing to the existence of similar schemes in the neighbouring States. As a result of tax competition, there is loss of revenue to all of them. With a joint decision to withdraw the tax incentive schemes in the concerned States at the same time, they would all stand to gain without any loss to the industries in the region.

NON-TAX REVENUE

The contribution of non-tax revenues (interest receipts, fees, user charges, rates, etc.) have been low and falling, until recently. In 1985–86, non-tax revenue, as a percentage of GSDP, was 1.88 percent. It fell to 1.34 by 1991–92. Since then, it has recovered somewhat, reaching 1.54 percent of GSDP in 1996–97. Augmenting non-tax revenues should be considered an important means for improving Kerala's State finances. These have considerable unexploited potential. Also, it is more justifiable to charge individuals who are the direct beneficiaries of services provided by the government when significant externalities or welfare motives are not involved, rather than charging the general taxpayer for financing these services.

The structure of non-tax revenues have been summarised in table 2.3. While the share of economic services have remained virtually unchanged during the period 1985–86 to 1996–97, the share of social services as well as interest receipts and dividends has gone down. The difference has been made up by an increased share of receipts from the general services. We consider this structural change somewhat undesirable. It will be seen that the social services account for a very large part of budgetary costs. Also, interests receipts and dividends reflect rather poor recoveries. As such it is desirable, that recoveries from social and economic services should be significantly increased. This issue is further considered in the discussion on subsidies in the next chapter.

The Task Force Report on Tax and Non-Tax Sources of Revenue [GoI, 1997(c)] lists many fees and rates (see annexure 3) that have not been revised for the last twenty years or more. We fully endorse the recommendations of the task force in this regard that would lead to a significant and speedy increase in the recovery of costs of various services provided by the State government. The report estimates an amount of Rs. 376.12 crore for the Ninth Plan period, divided into year-wise amounts, and an amount of Rs. 63 crore from revision of tuition fee for medical education courses and from forests, giving an amount of Rs. 439.12 crore over the Ninth Plan period. For the year 1998–99, the additional non-tax revenue estimated by the task force is about 38 percent higher than the budget estimate of 1998–99.

Table 2.3: Non-Tax Revenues: Relative Importance of Different Components

(Percent of total non-tax revenue)

	1985-86	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
Interest receipts, dividends & profits	17.47	11.55	9.83	9.65	9.76	10.69	19.82	11.61
General services	17.62	40.15	35.19	31.42	27.58	27.30	25.11	30.73
Social services	18.30	14.90	13.02	12.29	12.97	11.58	11.38	9.20
Economic services *of which*	46.61	33.41	41.96	46.65	49.69	50.43	43.69	48.46
Forests	30.02	17.88	23.70	28.17	31.88	34.54	30.02	31.53
Major & medium irrigation	0.87	0.99	0.71	0.52	0.73	0.45	0.50	0.43
Minor irrigation	3.28	0.49	0.52	0.18	0.15	0.14	0.09	0.18
Road and water transport	1.01	0.67	0.59	0.97	0.64	0.68	0.67	3.43
Animal husbandry	1.59	1.13	1.10	1.04	1.08	0.90	0.79	0.84
Industries	0.14	1.39	1.95	5.56	4.90	1.85	2.72	0.42
Others	9.71	10.86	13.39	10.21	10.30	11.87	8.91	11.65
Memo: non-tax revenue (Rs. crore)	142	164	189	181	174	209	235	279

Source: CAG, relevant years.

RESOURCE TRANSFERS FROM THE CENTRE

There has been a turnaround in the relative roles of grants and shared taxes. While the share of grants has been going down, the decline has been compensated to some extent by an increase in the shared taxes. However, considered together, the resource transfers to the State from the centre in the form of shared taxes and grants, measured as a percentage of GSDP, have fallen. Net loans have also fallen. Thus, the total transfer from the centre including net loans have decreased from 12.30 percent of GSDP in 1985–86 to 6.31 percent of GSDP in 1996–97. The relative contribution of different modes of resource transfer are summarised in table 2.4.

Table 2.4: Resource Transfers from the Centre

(Percent of GSDP)

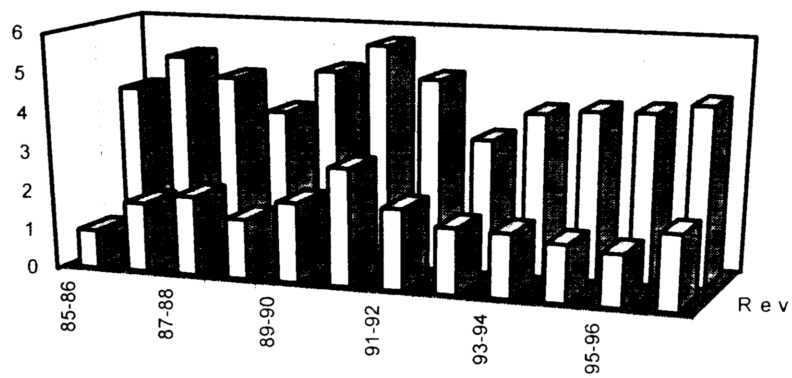
	1985-86	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
Total Transfers	12.30	7.97	6.92	7.22	7.32	7.72	6.72	6.31
Shared Taxes	2.75	3.45	3.29	3.45	3.34	3.11	3.45	3.72
Grants	3.86	2.61	2.09	2.33	2.23	2.34	1.56	1.47
Net Loans	5.68	1.91	1.54	1.44	1.75	2.27	1.70	1.12

Source: CAG, relevant years.

FISCAL DEFICIT: COMPOSITION AND FINANCING

As noted earlier, the basic fiscal problem of Kerala is a high debt-GSDP ratio that has arisen because of the persistent use of high fiscal deficit to finance government revenue expenditure (charts 6 and 7). In table 2.5, the composition and financing of fiscal deficit have been summarised. It will be observed that, measured as a percentage of GSDP, fiscal deficit amounted to 4.55 percent in 1996–97, of which about 2 percentage points were accounted for by revenue deficit alone. In 1985–86, this figure was close to 1 percent of GSDP. On the other hand, the share of capital outlay financed by fiscal deficit has been falling. In a number of years, withdrawal for funds has been used as a method for financing fiscal deficits to a noticeable extent, significantly during 1992–93 and 1996–97.

It is clear that for a number of years, fiscal deficit has remained in the range of 4 to 5 percent of GSDP. The primary deficit (table 2.1) has been about 1.2 percent of GSDP in recent years. These levels of fiscal and primary deficits have implied a steadily increasing outstanding debt to GSDP ratio given the effective interest and growth rates.



Charts 6 : Fiscal and Revenue Deficits

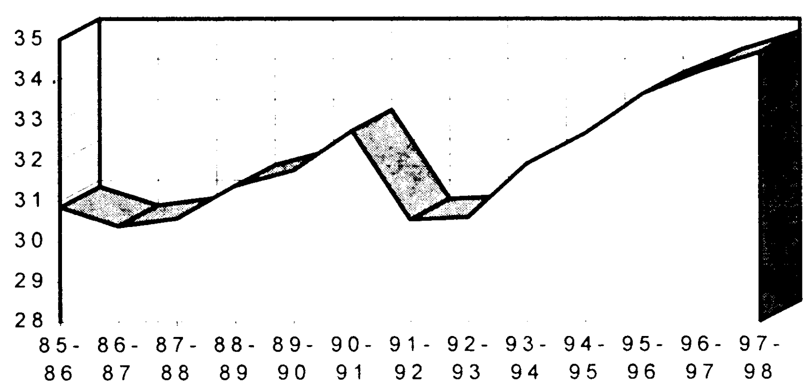


Chart 7 : Debt to GSDP Ratio (%)

CONTINGENT LIABILITIES

Debt-liability of the State government is in fact understated until the repayment guarantees given by the State government to public sector undertaking loans are also considered. Such guarantees (outstanding amount) have risen from Rs. 914 crore in 1987-88 to Rs. 1863 crore by the end of 1996–97, in addition to which an amount of Rs. 85 crore is also outstanding on account of interest. Several of the PSUs are running operating losses and are unable to service their debt. Not only past repayment and interest payments have been defaulted, future debt servicing also stands a strong chance of being defaulted. The State government charges a guarantee commission at a nominal rate of 0.75 percent on the basis of the principal and interest outstanding (in default) each year. Guaranteeing loans of non-viable PSUs amounts to creating deferred budgetary liabilities. Possibly for this reason, Kerala has earned a sub-investment grade rating from agencies like Credit Rating Information Service of India Ltd. (CRISIL).

Table 2.5: Composition and Financing of Fiscal Deficit (1985–86 to 1996–97)

(Percent of GSDP)

	1985-86	1990-91	1991-92	1992-93	1993-94	1994-95	1995-96	1996-97
Fiscal deficit (estimated from definition)	4.29.	5.66	4.87	3.42	4.15	4.27	4.30	4.55
Financing of fiscal deficit								
1. Net borrowing[1]	8.15	5.24	4.20	3.75	4.83	6.05	4.30	3.92
2. Withdrawal of funds[2]	-0.48	0.23	0.05	0.30	-0.23	-2.00	0.00	0.67
3. Ways and means adv. (RBI & Center)	-2.97	0.26	0.08	0.41	-0.82	-0.04	0.00	0.00
4. Overall deficit	-0.42	-0.08	0.34	-0.87	0.38	0.09	0.04	0.06
5. Contingency fund (net)	0.01	0.02	0.21	-0.18	0.00	0.17	-0.04	-0.10
Composition of fiscal deficit								
i. Revenue deficit	0.99	2.99	2.08	1.69	1.65	1.48	1.34	1.93
ii. Capital outlay	2.74	1.82	1.63	1.39	1.61	1.65	1.88	1.87
iii. Net lending	0.56	0.86	0.87	0.59	0.89	0.97	1.12	0.83

Source: Estimated from data given in CAG, relevant years; and CSO, relevant years(a).

Notes: 1. This comprises loans from the centre, market borrowing and small savings and provident fund, reflecting change in the outstanding debt stock. This equals fiscal deficit only when items 2, 3, 4 and 5 are all zero.
2. This captures net transactions in public account excluding small savings and provident fund.

STATE FINANCE COMMISSION

The broad approach of Kerala State Finance Commission (KSFC) has been to: (i) distinguish between traditional functions and responsibilities; and (ii) additional developmental responsibilities. While traditional functions may continue to be supported by the traditional financing methods (tax shares, grants, own sources but with improvement in the mechanism of collection), there is need for augmenting more resources for the new developmental functions. New functions relate to development of new assets and maintenance of old assets that will be transferred to the local bodies. Annexure 6 gives a summary of the approach of KSFC.

The financial position of the local bodies in Kerala is comparatively better than that of the local bodies in other States. The fiscal autonomy of local bodies, which is defined as the ratio of locally raised revenue in total local expenditure, is around 50 percent in Kerala, whereas the all-India average of the same is around 11 percent. The SFC has noted that this high fiscal autonomy is mainly due to some of the potent and buoyant revenue resources in the hands of the local bodies. The building tax, profession tax and entertainment tax are the major taxes at local level and they together constituted around 50 percent of the total revenue of local bodies in Kerala. The building tax continued to be one of the most lucrative source of revenues for the rural local bodies and constituted around 60 percent of the own tax revenue in 1993-94. During the same year, the share of profession tax and entertainment tax in own tax revenue was 24.47 and 13.54 percent respectively.

Apart from own resources, tax transfers and grants from the State government constitute around 45 percent of the total receipts of the *panchayats*. In Kerala, stamp duty on transfer of property and basic tax or land tax are assigned taxes, while motor vehicle tax is the only shared tax which is based on the compensatory principle.

In the allocation of Plan funds, the total volume should be determined by the State level planning authority but principles of horizontal distribution have been reconsidered by the KSFC. Financial requirements for the maintenance of roads, buildings and other assets transferred to the local bodies have been separately assessed.