5. Fiscal Prospects

The period under review is 1997–98 to 2001–02. The State economy has entered this Ninth Plan period with some critical features, *viz.*, (i) wages and salaries and pensions are being revised upwards by nearly a factor of 20 percent; (ii) the State has embarked upon an ambitious Ninth Plan with an associated large borrowing programme; (iii) economic growth has decelerated in recent years, and current prospects indicate that it will be around five percent or less, given recessionary tendencies in the rest of India and abroad; and (iv) a large part of Plan funds will be handled by the local bodies. Under these circumstances, the fiscal prospects have been examined with reference to two scenarios – a base scenario and a reform scenario. The projections presented here should only be taken as outlining the broad contours of adjustment.

Base Scenario

The basic features underlying the base scenario are listed below:

- Nominal growth rate has been set at 12.5 percent per annum. This would be consistent with an inflation rate of 7 percent and a real growth rate of just below 5.2 percent per annum.

- Wages and salaries are revised upwards for 1998–99 by a factor approximately of 20 percent. This is consistent with the salary revisions accepted by the State government in November, 1998. The DA component is protected against inflation for subsequent years. Growth in the number of employees is provided at the historical rates.

- Borrowing by the State government is projected as per the financing profile with respect to the approved size of the Ninth Five Year Plan.

- Tax revenues are projected on the basis of historical buoyancies.

The model works as follows. First, total receipts are worked out on the basis of projections of own tax revenues, share in central taxes, non-tax revenue and grants. We notice that in the first two years, i.e., 1997–98 and 1998–99, already there is a cut in the Plan size due to resource constraints. For the remaining three years, we have used ninety percent of the originally envisaged outlays. Net borrowing is worked out on the basis of the requirements of the Ninth Plan, adjusted in this manner. Grants are worked out with reference to the Plan as also from the *Report of the Tenth Finance Commission* for non-Plan grants and grants for upgradation and for local bodies. Together, this provides a profile of total receipts for the five-year period. From these, total non-discretionary expenditure, consisting of interest payments, pensions, wages and salaries and compensation and assignments to local bodies are set aside. This provides a balance of resources which may be utilised for meeting Plan expenditure as also other expenditure claims like loans and advances, maintenance and subsidies, and current transfers. The three remaining claims on budgetary resources are then worked out. Loans and advances and subsidies and current transfers are projected on the basis of historical growth rates. Maintenance is linked to the Tenth Finance Commission (TFC) estimates. Since, the TFC estimates relate to only a limited number of sectors, these are factored up by working out the ratio of maintenance expenditure in 1995–96 as given in the economic classification with respect to the TFC estimates for the same year. This implies a real growth in maintenance expenditure during the projection years of about 3 percent per annum, over and above an inflation cover of 7 percent per annum.

The gap between total receipts and total estimated expenditure indicates the degree of adjustment that is required. This adjustment can be brought about by cutting down the Plan size as also by adjustment in non-Plan expenditure. Since, we have information for the first two years, namely, 1997–98 (revised estimates) and 1998–99 (budget estimates), we have some idea as to how adjustments took place in these two years. In 1997–98, even as a huge amount of expenditure was financed by withdrawal from funds, Plan size had to be cut. Withdrawal from funds is not a source which can be regularly resorted to year after year. In 1998–99, the Plan size would have to be cut by a much larger amount. We also see, that the gap would continue to widen in the remaining three years. The base scenario indicates that apart from cuts in non-Plan expenditure, the State will have to settle for a lower Plan size. We have indicated the results if 90 percent of the original Plan outlays are sustained implying a cut in the original borrowing programme. Still there would be a steadily rising fiscal deficit and primary deficit measured as a ratio of GSDP. Also in 1998–99, there is a steep one time rise because of impounding of salary arrears into the provident fund.

The profile of the main budgetary aggregates for the base scenario is summarised in table 5.1. We observe that the fiscal deficit rises to 5.25 percent of GSDP by 2001–02 and the primary deficit is about 1.37 percent of GSDP. The outstanding debt to GSDP ratio increases by nearly 5 percentage points between 1997–98 to 2001–02. Even while the fiscal scenario deteriorates in this manner, the targeted Plan outlay is not met. There is thus a clear cut need to undertake fiscal reforms that would be consistent with better growth performance and more acceptable values of the fiscal parameters.

DESIGNING FISCAL REFORMS IN KERALA

Fiscal reforms are designed here keeping in mind two prime objectives, *viz.*, (i) to fashion fiscal policies that would prove to be conducive to economic growth, and (ii) restore fiscal balance at a sustainable level of debt.

Table 5.1: Base: Summary of Results

(Percent of GSDP)

	1997-98	1998-99	1999-00	2000-01	2001-02
Revenue Receipts	**20.32**	**20.01**	**20.03**	**20.19**	**20.37**
Own tax revenue	12.84	12.93	12.98	13.17	13.36
Share of Central taxes	3.73	3.87	3.95	4.03	4.11
Non-tax revenue	1.55	1.52	1.48	1.46	1.43
Grants	2.20	1.70	1.62	1.54	1.46
Total capital receipts	7.52	6.54	4.91	5.14	5.33
Total receipts	**27.84**	**26.55**	**24.93**	**25.33**	**25.70**
Non-discretionary expenditure	14.01	14.44	14.40	14.02	13.75
Interest payment	3.48	3.58	3.88	3.86	3.88
Wages and salaries	7.55	8.21	7.66	7.15	6.70
Balance of Resources	**13.83**	**12.11**	**10.53**	**11.30**	**11.95**
Plan outlay financed by Budgetary resources[1]	**7.22**	**7.34**	**7.14**	**7.47**	**7.75**
Maintenance	1.14	1.12	1.09	1.07	1.04
Subsidies and current transfers	5.02	5.08	5.14	5.20	5.26
Total estimated expenditure	**28.76**	**28.83**	**29.01**	**29.04**	**29.12**
Required adjustment in expenditure	**0.92**	**2.28**	**4.08**	**3.71**	**3.42**
Fiscal deficit	4.72	6.72	4.82	5.05	5.25
Primary deficit	1.24	3.13	0.93	1.19	1.37
Outstanding debt	**35.14**	**37.96**	**38.56**	**39.33**	**40.21**

Note: 1. After adjusting for extra budgetary resources for the Plan.

TAXES

We are not looking for revenue-oriented additional exploitation of the tax base. Tax reforms, even while being revenue-neutral, should encourage trade, as well as domestic production. Removal of distortions through implementation of VAT, and alignment of tax rates with the neighbouring States and union territories (UTs), (e.g., Mahe as an enclave of Pondicherry) so as to discourage tax-competition on the basis of joint decisions in areas like incentives for new industries and an overall improvement in the tax administrative machinery should, therefore, constitute the agenda for tax reforms.

The Task Force of the State Planning Board on tax and non-tax sources of revenue (March, 1997) has identified both tax and non-tax sources for additional resource mobilisation. On the tax side, the identified sources relate to (i) withdrawal of sales tax incentives to new industrial units; (ii) collection of arrears under sales tax and AIT through an amnesty scheme; (iii) improvement in tax administration; (iv) expansion of tax base for AIT by redefining standard area; (v) luxury tax on residential buildings; and (vi) augmented revenue from stamp duties and registration fees by introducing a system based on assessment of fair values. They have also suggested the levy of a consignment tax. We have taken their estimates for additional revenue for tax sources except those for the consignment tax.

NON-TAX REVENUES

Non-tax revenues should constitute an important platform for garnering additional revenues. In so far as they relate to user charges for the social and economic services, they also reduce the degree of subsidisation of government services. For a variety of these services, the user charges have not been revised for a long period. Unless cost-escalation is properly reflected in the user charges, it is the general tax-payers who are forced to subsidise the direct users of these services. Apart from yielding additional revenues, this will also improve the quality of services provided by the government since the users who pay higher prices also demand better services. In addition to social and economic services, we also suggest augmented recoveries in the case of general services where rates and fees have not been revised for a long time. The Task Force [GoK,SPB,1997(c)] referred to above has also provided estimates for additional non-tax revenues during the Ninth Plan period. We have used these estimates.

EXPENDITURE RESTRUCTURING

Since revenue side adjustments are not going to be enough, we need to have a clear outline of the direction in which expenditure ought to be restructured. Also priorities need to be clearly set so as to indicate what expenditures ought to be cut in case of revenue shortfall. Since, the room for adjustment is limited to non-discretionary expenditure, we suggest that on the non-Plan side, maintenance expenditure should be protected. To a limited extent there is a possibility of reducing expenditure on salaries by curtailing the rate of growth of employment. In the reform scenario, we have set the net growth of government employment at zero percent.

As far as Plan expenditures are concerned, we have indicated an order of priority, giving emphasis to (i) the objective of decentralisation; and (ii) protection of social and community sectors which include various welfare related activities. In the economic sectors, high priority has been accorded to irrigation, power and transport. The resource requirement for these sectors for the Ninth Plan period were worked out by specific task forces and steering committees set up by the State Planning Board. These estimates were then utilised in the preparation of the State Plan. However, in the reform scenario, we set up the objective that the last year of adjustment of the debt to GSDP ratio should stabilise. As a result, the size of the Plan is still to be curtailed, but it is higher in nominal terms than what was possible in the base scenario, due to augmentation in revenues and other adjustments.

We have targeted subsidies and current transfers for a reduction as compared to the base scenario. In the reform scenario no real growth has been provided in these. Where resources still fall short, this item is further used for residual adjustment. This happens in two years: 1999–2000 and 2000–01.

We have set the nominal growth of GSDP at 14 percent per annum. As a larger Plan is provided for in the reform scenario, we expect that it will be consistent with higher growth. The State Planning Board had made estimates of resource requirement for the Plan to achieve a growth rate of 7 percent per annum. The main aggregates under the reform scenario have been summarised in table 5.2. Fiscal deficit would come down to 4.79 percent of GSDP by 2001–02 while primary deficit is at 1.16 percent of GSDP. The outstanding debt to GSDP ratio is stabilised at 39 percent.

Table 5.2: Reform: Summary of Results

(Percent of GSDP)

	1997-98	1998-99	1999-00	2000-01	2001-02
Revenue Receipts	**20.06**	**21.44**	**21.29**	**21.30**	**21.35**
Own tax revenue	12.67	14.07	14.05	14.19	14.33
Share of Central taxes	3.68	3.77	3.80	3.82	3.85
Non-tax revenue	1.53	1.95	1.88	1.84	1.80
Grants	2.17	1.66	1.56	1.46	1.37
Total capital receipts	7.42	6.51	4.84	4.98	5.08
Total receipts	**27.48**	**27.94**	**27.57**	**26.72**	**26.31**
Non-discretionary expenditure	13.83	14.07	13.41	12.90	12.50
Interest payment	3.43	3.49	3.73	3.66	3.63
Wages and salaries	7.45	8.00	6.93	6.39	5.90
Balance of Resources	**13.65**	**13.87**	**14.76**	**13.82**	**13.81**
Plan outlay financed by Budgetary resources[1]	7.12	7.15	7.55	7.49	7.75
Maintenance	1.13	1.09	1.05	1.01	0.97
Subsidies and current transfers	4.96	4.65	4.37	4.10	3.85
Total estimated expenditure	28.38	27.78	27.57	26.72	26.31
Required adjustment in expenditure	**0.90**	**-0.16**	**0.00**	**0.00**	**0.00**
Fiscal deficit	4.66	6.54	6.08	5.23	4.79
Primary deficit	1.23	3.05	2.34	1.56	1.16
Outstanding debt	**34.68**	**36.96**	**38.50**	**39.00**	**39.00**

Note: 1. After adjusting for extra budgetary resources for the Plan.

A comparison of the base and reform scenarios puts in perspective the fiscal prospects of the State. Continuance of present trends, as captured in the base scenario, would imply a deepening fiscal crisis, even while the Plan has to be cut down, and the State experiences a lower growth rate. Concerted effort at reforming the tax regime would make it more growth-oriented by minimising distortions in productive activities. Further, additional tax and non-tax revenues would ensure a larger Plan, as compared to the base scenario and expenditure is incurred in developmental and high priority expenditures including maintenance. It may be noted that while the Plan is larger as a percentage of GSDP in the reform scenario, it appears smaller by a slight margin by 2001–02 due to the higher growth rate of GSDP in this scenario. As more investment takes place, an impetus for higher growth based on the State's own efforts is brought about.

The impact of the reforms relative to the base scenario is summarised in table 5.3. It is seen that adjustments have been brought about by (i) increase in tax and non-tax revenues; (ii) increase in capital expenditure; (iii) increase in maintenance expenditure; (iv) reduction in wages and salaries; (v) reduction in other revenue expenditure; and (vi) increase in the real GSDP growth rate. We think that the avenues of reforms outlined above are all feasible and within reach. We also think that their effects are substantial and efficiency-augmenting.

These two scenarios are intended to serve as benchmarks. We notice that even in the reform scenario, the debt to GSDP ratio is still very high. Reference to this scenario also highlights the risk if there is a slippage from the revenue targets or laxity in expenditure restructuring. In particular, debt to GSDP ratio would cross 40 percent. As such, the State should initiate the process of essential adjustment without further delay.

Table 5.3: Major Sources of Adjustment

(Rs. crore)

	1998-99	1999-00	2000-01	2001-02
Own tax revenue	640.30	783.40	958.70	1173.00
Non-tax revenue	203.50	225.90	256.80	293.40
Total capital receipts	60.00	774.40	360.00	-19.60
Wages and salaries	0.00	-211.90	-224.20	-236.90
Subsidies and current transfers	-127.80	-282.30	-467.90	-689.60
(Percent of GSDP)				
Own tax revenue	1.48	1.58	1.70	1.83
Non-tax revenue	0.47	0.46	0.46	0.46
Total capital receipts	0.14	1.57	0.54	-0.03
Wages and salaries	0.00	-0.43	-0.40	-0.37
Subsidies and current transfers	-0.29	-0.57	-0.83	-1.07

In conclusion, we may recapitulate that while the strategy of extensive participation of the government in the social sectors succeeded in Kerala, the same strategy did not bear fruits in the economic sectors. For the social sectors, markets could not have been relied upon to provide universal coverage in areas like elementary education and primary health at near zero prices. On the other hand, the government and the public sector did not succeed in ensuring adequate returns on capital invested in the economic sectors. Without being successful on the economic side, even the success on the social side will slip away. It is, therefore, imperative to recast the role of the government in Kerala such that its primary participation in the social sectors and in a limited number of economic sectors like irrigation and infrastructure would be sustained by and give feedbacks to the growth impetus of the economy based on efficiencies inculcated into the system by private enterprise and innovations which would thrive in a well designed fiscal, economic, and regulatory framework. In this perspective, a fiscal policy reorientation has been put forward here. When, based on a sound fiscal foundation, the State economy begins to thrive, Kerala's would be an example for many Indian States to emulate.