FISCAL MANAGEMENT IN KERALA:
CONSTRAINTS AND POLICY OPTIONS

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Fiscal Management in Kerala: Constraints and Policy Options

States in India with the exception of a few Special Category States and the National Capital Territory of Delhi have been reeling under severe fiscal crisis from the middle of the eighties.[1] As for Kerala, its fiscal distress dates back to a much earlier period. Kerala had incurred budgetary deficits in its revenue and capital accounts as far back as in the Fifth Five Year Plan period (1975-76 & 1976-77). The amounts involved were, however, small. During the Sixth and the Seventh Plan periods (1980-90), Kerala had overall deficits during four years each. The amounts involved became larger.[2] During the eleven year period ended in 2000-01, which coincided with the post-liberalisation period with all its emphasis on containing budgetary deficits, Kerala had deficits during six years (See Table 1). Revenue deficits became a continuous phenomenon for Kerala from 1983-84 onwards while the phenomenon appeared only from 1987-88 for other States taken as a group (hereafter referred to as All States).

Note:1. An earlier version of this paper was presented in the seminar on 'The Evolution of Financial Distress of the Governments of Southern States' organised by the Madras School of Economics on 16th July, 2003.
2. The views expressed in this paper are those of authors and do not necessarily represent the views of the Centre.

[1] Arunachal Pradesh, Assam, Himachal Pradesh, Jammu & Kashmir, Manipur, Meghalaya, Mizoram, Nagaland, Sikkim, Tripura, and Uttaranchal belong to the Special Category of states.

[2] For more details about the origin and dimensions of Kerala's fiscal crisis, See George K.K., *Limits to Kerala Model of Development*, Centre for Development Studies, Thiruvananthapuram, 1999. The book traces the evolution of Kerala's fiscal crisis from 1974-75 to 1997-98. The book also discusses the contributory factors for the crisis. The impact of fiscal crisis on the State's development crisis and the development options available to the State are also discussed in the book.

Major Fiscal Indicators

The major fiscal indicators for Kerala and All States are given in Table 2. The magnitude of revenue deficits of Kerala in relation to its revenue expenditure was steadily rising from 1996-97 after declining steeply from 1990-91 onwards. In many years, revenue deficits formed more than ten per cent of the total revenue expenditure. During the three-year period ended in 2000-01, the ratio of Kerala's revenue deficit to revenue expenditure exceeded twenty per cent. During 1999-2000, it was more than 30 percent. Almost similar trends are seen in the average ratios for all States. But Kerala's ratios were higher than the average of All States during all but one year of the nineties.

Gross Fiscal Deficit (GFD) to GFD Expenditure also showed similar trends and stood at 30.8 per cent in 2000-01.[3] The average ratio of GFD to GFD expenditure for Kerala which stood at 20.9 per cent during 1985-90 and 20.7 per cent during 1990-95 went up sharply to 26.1 per cent during 1995-2000 (Table 2). There was an almost steady increase in this ratio from 1992-93. But the ratio came down from the peak of 36.4 per cent in 1999-2000 to 30.8 per cent in 2000-01.[4] In fact, GFD showed an absolute decline in this year largely due to the severe expenditure compression effected out of sheer compulsion. Similar trends are visible in the case of All States too. But the ratios for Kerala were more than that of All States except in 1992-93 and 1998-99. An inter-State comparison shows that Kerala was fourth in this respect among the fourteen major States after West Bengal, Gujarat and Orissa.

Table 3 shows the major fiscal indicators in relation to Gross State Domestic Product (GSDP) of Kerala. The Table shows that the ratios of all fiscal indicators to GSDP were coming down till 1995-96 but started rising from 1996-97 till 1999-2000 (the latest year for which even provisional GSDP data are available). In 1999-2000, the revenue deficits (RD) formed 5.8 per cent of the GSDP as compared to 2.6 per cent in 1990-91. The ratio of gross fiscal deficit (GFD) to GSDP stood at 7.3 per cent in 1999-2000 as against 4.8 per cent in 1990-91. The primary deficits in relation to GSDP rose from 2.8 per cent in 1990-91 to 4.1 per cent in 1999-2000. The jump in the primary deficit indicates that there are reasons other than interest outgo, the reasons cited very often, for the State's fiscal crisis.

The uses of funds borrowed to finance the growing GFD are shown in Table 4. This table shows that the average ratio of revenue deficit to GFD in case of Kerala was increasing steadily from the second half of the eighties. In the nineties, the ratio which was coming down almost steadily till 1995-96 started climbing up very fast to reach 81.2 per cent in 2000-01. In respect of this ratio, Kerala's position was the second highest in 2000-

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[3] Both the Revised Estimates and the Budget Estimates are quite different from the Accounts and therefore the former estimates, though available for later years, are not utilised for our analysis. This makes our study slightly out dated, but more reliable.

[4] GFD expenditure is the total of revenue expenditure, capital outlay and net lending. For these and other terms, see Reserve Bank of India (RBI), *State Finances*.

01. Only Maharashtra had a higher ratio among the fourteen major States. The high ratio of revenue deficit to GFD implies lower ratios of capital outlay and net lending to GFD. In respect of the ratio of capital outlay to GFD, Kerala's position was thirteenth among the major States. Only West Bengal followed Kerala. In regard to the ratio of net lending to GFD, Kerala's position was the lowest. These ratios indicate that most of the borrowings are utilised not for direct capital expenditure or for making investments or for extending loans but for financing the revenue expenditure.[5]

The steady increase in GFD had led to steady increase in the ratio of outstanding debt to GSDP. The ratio went up from 27.0 per cent in 1990-91 to 30.4 per cent during the year 1999-2000. Apart from these increasing borrowings, Kerala's pattern of borrowings to finance the fiscal deficit has high potential for destabilising its finances in future. The State has been relying increasingly on high cost funds like provident funds, savings deposits, non-market borrowings etc. to meet its fiscal deficit. The share of loans from the Centre and net market borrowings in financing GFD showed a steep decline during the period. Almost similar trends are seen in the case of All States also.

This pattern of financing fiscal deficit is reflected in the changing composition of Kerala's public debt (Table 5). The share of provident funds etc.[6], went up from 26.5 per cent at the end of March 1991 to 33.5 per cent at the end of March 1996 and further to 42.6 per cent at the end of March 2001. The share of internal debt also went up though marginally during this period. [7] Its share after showing a marginal decline from 24.8 per cent at the end of March 1991 to 24.6 per cent at the end of March 1996 went up to 27.7 per cent at the end of March 2001. The share of Central Government loans in the State's outstanding liabilities came down steeply from 48.8 per cent to 41.9 per cent and further to 29.7 during this period. This ratio for Kerala was considerably lower than that of All States during all the three years. Similar trends are seen for All States but not as pronounced as in Kerala. In the share of both internal debt and provident funds etc. Kerala's position was much higher than that of All States.

The major fiscal indicators given above conceal as much as they reveal. In the current system of cash accounting, as against the system of accrual accounting, followed in India, both payables and receivables are not shown in the budget. Kerala State Electricity Board (KSEB) for instance, owed the government a sum of Rs.1,753 crores towards interest and repayment of principal at the end 1999-2000. They also default on payment of electricity duty collected by them on behalf of the State Government. But the government, it is

[5] Not that we give much importance to this distinction between revenue expenditure and capital expenditure. As may be seen from our discussion later in this paper, the financial returns from capital expenditure (capital outlay, investments and loans given by government) are not much different from those of the revenue expenditure. The returns from capital expenditure come back to the State budget directly by way of dividends and profits, interest and user charges and indirectly as tax revenue. As may be seen from our discussion that follows, the rate of dividend and the rate of interest are lower than the ratio of non-tax revenue receipts to revenue expenditure.

[6] RBI, op.cit.

[7] Internal Debt does not include National Small Savings Fund (NSSF) which is included under Loans and Advances in the year 2000-01. This adjustment is made to facilitate comparison over the years.

reported, owes the KSEB a sum of Rs.4374 crores towards subsidy.[8] The State government has accumulated a huge number of unpaid bills. The present government claims to have inherited a bill of Rs.1400 crores towards payment of PWD contractors and Rs.33 crores towards bills of pharmaceutical companies. Pensions including social security pensions were in arrears. Dues to the government servants for DA installments and a portion of salary increments were also in arrears[9].

The budgets do not indicate the contingent liabilities of the governments. Faced with budgetary crisis, the governments are forced to reduce their budgetary support to the public sector undertakings (PSU) and cooperatives. Therefore, it has started guaranteeing the loans secured by the latter from financial institutions. Given the precarious financial position of the PSUs and the cooperatives, the risk to the State governments arising out of the revocation of guarantees is quite high. The amount of outstanding guarantees issued by Kerala government stood at Rs.9553 crores at the end of March 2001. These outstanding guarantees formed 12.7 percent of the GSDP of Kerala in 1999-2000. It may be noted that similar trends are visible for All States. But, the ratios for Kerala were much higher than the corresponding ratios for All States during the last seven years except in 1996-97.

Fiscal Crisis : Contributory Factors

Table 6 shows the growth of revenue receipts and revenue expenditure during both halves of the nineties. While the average growth rate of revenue expenditure remained the same (15.6 per cent) during both the five-year periods, the average growth rate of the total revenue receipts decreased sharply from 17.7 per cent in the first half of the nineties to just 10.1 per cent during the second half. Further disaggregation of the growth of revenue receipts shows that the average growth rate in State's own revenue during the second half of the nineties was almost half the growth rate of the first half. As far as Kerala's own revenue is concerned, the growth rates of both tax revenue and non-tax revenue declined steeply. But the decline in the growth rate of own non tax revenue was steeper than that of own tax revenue (20.9 per cent to 4.8 per cent in the case of own non-tax revenue as against a decline from 20.4 per cent to 11.7 per cent in own tax revenue). The growth in Central revenue transfers also showed a decline. The average growth rate of the State's share in Central taxes came down from 16.5 per cent to 9 per cent. But the growth rate of grants from the Centre increased marginally from 6.9 per cent to 9.1 per cent. Almost similar trends are seen in the case of All States.

Table 7 shows the trends in current revenue and expenditure in relation to GSDP. The revenue expenditure to GSDP ratio which was declining till 1996-97 started climbing up since then to reach 18.5 per cent in 1999-2000. Revenue receipts in relation to GSDP on the other hand, after going up from 14.6 per cent in 1990-91 to 14.9 per cent in 1993-94, came down almost steadily to reach 12.7 per cent in 1999-2000. The own revenue receipts to GSDP ratio after climbing up to 10.1 per cent in 1993-94 from 9.4 per cent in 1990-91 came down to 9.2 per

[8] Statement of one of the KSEB union leaders as reported in The Hindu dated 15/6/2003.
[9] Kerala Finance minister's Statement as reported in The Hindu dated 6/06/2003.

cent in 1999-2000. The decline in Central revenue transfers was much more steeper. Central transfers to GSDP ratio fell from 5.2 per cent in 1990-91 to 3.6 per cent in 1999-2000.

The Changing Structure of State Revenues

The structure of State revenues had undergone major changes in the nineties (Table 8). The share of State's own tax revenue increased steadily from 55.8 per cent in 1990-91 to 62.4 per cent in 1995-96 and further to 67.2 per cent in 2000-01. In the share of State's own tax revenue in the total revenue, Kerala was far ahead of All States during all the three years. Share of State's own non-tax revenue increased slightly during the first half of the nineties but decreased during the second half. In respect of the share of own non-tax revenue, Kerala was lagging behind All States during all the three years. But if we take the share of State's own revenue as a whole, Kerala was ahead of all the States during all the three years. The share of State's own revenue increased steadily to reach 74.8 per cent in 2000-01 from 64.5 per cent in 1990-91. Kerala was ahead of all States in this respect during all the three years. The share of aggregate revenue transfers to Kerala came down steadily. In the share of Central taxes in total revenue, there was a steady decline during the three years. In this respect, Kerala lagged behind All States in all the three years. In the share of grants from the Centre too, there was a steady and sharp decrease during the three years. In respect of both the components of Central transfers, Kerala lagged behind All States.

The decline in the share of Central revenue transfers in the State's revenue budget is on account of two factors. Firstly, there was a decline in the share of revenue transferred to States from the Central budget. The share of total revenues of the Central government transferred to all States put together came down from 38.5 per cent in 1991-92 to 36.2 per cent in 2000-01. Besides, the average growth rate of total Central revenue came down from 15.1 per cent during the first half of the nineties to 12.0 percent during the second half. The average annual growth rate of Centre's gross tax revenue decreased from 14.3 per cent during the first half of the nineties to 11.3 per cent during the second half. The average annual growth rate of Centre's non-tax revenue also came down, from 19.1 per cent to 14.8 per cent.

Trends in Tax Revenue Mobilisation

We had seen earlier that the deepening fiscal crisis in the second half of the nineties was more on account of the low growth rate of revenue receipts in relation to the growth rate of revenue expenditure. During recent years tax efforts of the State government were slackening. The tax-GSDP ratio came down from 8.9 per cent in 1993 – 94 to 8.3 per cent in 1999-2000 after going up to 9.1 per cent in 1997-98.[10] A disaggregated analysis shows that average growth rate of revenue from all taxes recorded a decline during the second half of the nineties. (Table 9) The average growth rate of taxes on income came down from 16.6 per cent during the first half of the nineties to (-) 14.2 per cent during the second half. The growth rate in revenue from taxes on property and capital transactions came down from 23.0 per cent to just 1.5 per cent. The rate of growth of taxes on commodities and services declined from 20.4 per cent to 13.1 per cent. Of the commodity taxes, sales tax showed a growth rate of only 13.8 per cent during the 1996-2001 period as against 20.6 per cent during the 1991-95 period. The average growth rate of revenue from State Excise declined from 21.8 per cent during the first half of the nineties to 16.3 per cent during the second half. The decline in growth of revenue from taxes on vehicles was only moderate (24.8 per cent to 21.4 per cent). Taxes and duties on electricity show a high degree of fluctuations largely due to the non-remittance or partial remittance of these duties to the government by the Kerala State Electricity Board (KSEB) during a number of years.

The Table 10 shows the performance of taxes in relation to GSDP during the nineties. Except for sales tax and taxes on vehicles, the performance of all the taxes was poorer in 1999-2000 than in 1990-91. There can be several reasons for the lower tax mobilisation of the State in recent years, some of them exogenous and some endogenous. The pattern of economic growth, though slow shows that growth is taking place more in the services sector. In fact, the agricultural sector dominated by cash crops is facing a crisis due to the inflow of imports consequent to the opening of the economy. This has affected the Plantation Tax and Agricultural Income Tax. There has also been a steep decline of revenue from stamps and registrations partly due to the fall in real estate prices which in turn was partly due to the fall in prices of agricultural commodities. As for commodity taxation, the State had been lowering the tax rates in recent years to prevent trade diversions. Most of the cash crops produced in the State are exported to other countries or to other States. The capacity of the State to tax both the inter-state trade and exports are constrained by Central legislation.[11]

Notwithstanding the above, additional resource mobilisation by tapping more effectively the tax revenue sources is both necessary and feasible. There is scope for additional revenue realisation by curtailing the widespread tax evasion and collecting the substantial tax arrears. The present political climate in the State and the weak, inefficient and corrupt administrative system facilitate tax evasion. The failure to modernize tax administration and to strengthen the information network has also contributed to tax evasion. In Kerala, the tax resistance is building up in recent years. The state-wide merchants' union, organised on trade union lines is not hesitant to use militant tactics to prevent inspection of their premises by sales tax officers.

Stronger Case for Non-tax Revenue Mobilisation

Our discussion so far indicates that there is perhaps a stronger case for additional resource mobilisation by exploiting the non-tax revenue (NTR) sources. The case rests on four grounds. Firstly, as was seen from Tables 6, NTR is not growing as fast as the tax revenue (both State's own tax and the share in Central government's taxes) and revenue expenditure. Consequently, the share of own NTR in the total own revenue has been declining steadily. Its share declined from 30.9 per cent in 1974-75 to 22.9 per cent in 1980-81 and to 13.5 per

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[10] Based on SDP data for 1999-2000 which are provisional. See Government of Kerala, *Economic Review- 2002-03*.
[11] For details, see George K K, op.cit, Chapter III.

cent in 1991. It stood at 10.1 per cent in 2000-01 (Table 11). The non-tax revenue mobilisation in relation to GSDP was also coming down as was seen from Table 7. The share of non-tax revenue in own revenue has been considerably lower for Kerala than that for All States throughout the eighties and the nineties. For All States, the ratio stood at 22.2 per cent in 2000-01. Thirdly, further mobilisation of NTR is absolutely essential for diversifying the revenue sources. Putting all the eggs in the tax basket is not a wise policy. Fourthly, the low recovery of costs of the expanding public services, financed almost exclusively by tax revenue and borrowings, will adversely affect both the efficiency and the equity of the budgetary system.

Structure of Non-tax Revenue

For understanding the reasons for the very slow growth of NTR, it is necessary to understand its composition. Non-Tax Revenue represents recovery of cost of public services rendered, interest on loans and advances extended and dividends on investments made, by the State government. It also includes receipts from State lotteries and forestry and royalties on minerals. Table 12 shows the changing pattern of NTR of Kerala and All States between 1990-91, 1995-96 and 2000-2001. There was a sharp decline in the share of interest receipts between 1990-91 and 2000-01. In the share of interest receipts, Kerala lagged far behind All States. The share of revenue receipts from both general services and social services came down. The share of receipts from economic services increased. The share of dividends and profits was very low. But their share remained more or less the same.

Interest Receipts

Capital transfers accounted for 39.7 per cent of the capital expenditure of Kerala in 1998-99. (The latest year for which Economic and Functional Classification of the Budget is available.[12]) Table 13 reveals the fluctuating trend in the ratio of interest received by the State government to its total outstanding loans and advances. The ratio of interest received to outstanding loans came down from 3.1 per cent in 1991-92 to just 1.0 per cent in 2000-01. It may be recalled that the average interest rate on State's market borrowings varied between 14.0 per cent in 1995-96 to 11.0 per cent in 2000-01.[13] There was heavy arrears in recovery of both the principal and the interest. The recoveries in arrears as a percentage of outstanding loans and advances increased from 36.9 per cent in 1991-92 and reached 41.8 per cent in 1999-2000. The arrears in recovery of interest were more than the arrears in recovery of the principal amount. The share of interest in total recoveries in arrears however came down from 71.4 per cent in 1991-92 to 63.7 per cent in 1999-2000.

An institution-wise break-up of recovery in arrears of both the principal and interest shows that it was the three statutory corporations which accounted for the lion's share of the arrears. Of these, Kerala State Electricity Board (KSEB) had the largest arrears of both interest and principal. Besides, the share of KSEB in arrears was

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[12] Department of Economics and Statistics, Government of Kerala, *Economic and Functional Classification of Kerala Government Budget- 1993-94 to 1998-99,* Thiruvananthapuram, 2000.

increasing during the nineties. As against, the share of Kerala State Road Transport Corporation (KSRTC) was coming down.[14] The Kerala Water Authority's (KWA) share in recovery of arrears was the second largest among the institutions. The share of Kerala State Housing Board (KSHB) was only negligible.

Dividends and Profits

The State's total investments accounted for 19.5 per cent of State's capital expenditure in 1998-99.[15] Dividends received during the year 2000-01 as percentage of outstanding investments at the beginning of the year was only 0.63 per cent (Table 14). The Table shows that none of the statutory corporations had contributed to the dividend income of the government in the last eleven years. The dividend rate of government companies was slightly better but still low (0.89 per cent). Only the investments in other joint stock companies, mostly in the private sector and some located in other States paid a reasonable dividend (9.31 per cent). Even among these companies, only fourteen out of the 34 companies paid dividends.[16] The rate of dividend paid by co-operative banks and societies was lower than that of even PSUs (just 0.16 per cent).

Return on Capital Outlay

Gross capital formation accounted for 40.8 per cent of the total capital expenditure of Kerala in 1998-99.[17] At the end of 2000-01, the cumulative capital outlay of Kerala at original cost amounted to Rs.7914 crores.[18] Of this, more than 77 per cent was on economic services, 17.0 per cent on social services and 6.0 percent on general services. The non tax revenue receipts (other than interest and dividends) as a percentage of capital outlay (other than investments) on different categories of services are given in Table 15. The Table shows that the rate of return on capital outlay ranged between 5.3 per cent in 1997-98 to 4.3 per cent in 1999-2000 during the last six years ended 2000-01. Surprisingly, the rate of return from capital outlay on general services (excluding State Lotteries) was the highest (27.8 per cent) followed by social services (7.5 per cent). The return from economic services was the lowest (2.8 percent) It is the low rate of return on economic services, which accounted for more than three fourth of the total capital outlay, which pushed down the return on aggregate capital outlay. The low return on capital outlay on economic services is partly due to the inefficiency in planning and implementing the projects. For instance, the financial results of irrigation works which accounted for a quarter of the total cumulative capital outlay show that their loss after taking into account the interest on capital outlay works out to 14.6 per cent.[19] As for the economic returns from irrigation projects, while huge investments had been made on them, the index of area under food grains came down steadily to 39.7 per cent in 2001-02. (Base- Average of triennium ending 1979-80).[20]

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[13] Reserve Bank of India (RBI), *State Finances*, 2002-03.
[14] Recovery in arrears of KSEB for 2000-01 is not available in the *Finance Accounts* for that year.
[15] *Economic and Functional Classification of Kerala Government Budget*, op.cit.
[16] Comptroller and Auditor General, *Finance Accounts of Kerala-2000-01*, Thiruvananthapuram.
[17] *Economic and Functional Classification of Kerala Government Budget*, op.cit.
[18] *Finance Accounts of Kerala 2000-01*, op.cit..
[19] Ibid.

The low returns on capital outlay are not surprising. Contrary to impressions shared by the laymen and the economists alike, not all capital outlay leads to creation of productive assets. Table 16 shows the gross fixed capital formation by type of assets of both administration and departmental enterprises. Building construction which does not directly generate revenue accounted for more than one fourth of the total capital formation. Roads and bridges with very little direct financial returns accounted for nearly a quarter of the capital outlay. Other construction (including irrigation works, which are perennially loss making) accounts for 41.9 per cent of the cumulative capital outlay. Equipment - transport and machineries together accounted for only 8.1 per cent of the capital outlay. Not all these are directly productive (See Footnotes to Table 14 for the items included under each of the above heads).

An erroneous impression is gathering around in the State that it is the Kerala model of development that has contributed to the present fiscal crisis of the State. It is often argued that, it is the larger allocation of public expenditure for non-revenue generating social services like education and health at the expense of economic services that has contributed to the fiscal crisis of the State. But this argument is not valid at all. The revenue receipts on capital outlay on economic services (2.8 per cent) were much lower than those on social services (7.5 per cent). Dividends on investments, mostly made in economic services was just 0.61 per cent. The effective interest rate on loans, almost wholly on economic services, was also low (1.0 percent).

Low Cost Recovery from Public Services

As seen earlier, NTR includes receipts from lotteries, forestry and wild life and royalties on minerals. The receipts from lotteries are not revenue received for rendering a public service. Revenue from forestry and wild life does not represent yield on capital outlay or recovery of revenue expenditure. It is mostly the return on a natural asset. The same is true about royalties from minerals which constitute the bulk of the revenue shown under the head 'industry'[21] (other than village and small industries). Unlike the usual discussions on States' non-tax revenue, particularly the aspects of recovery of revenue expenditure, hidden subsidy, user charges etc., our discussion excludes these three items as these revenue receipts do not really represent recovery of costs for public services rendered. Some of these heads are not available to all the States. For example, five out of the fourteen major States did not operate State lotteries. Further, the importance of these three sources varies considerably among the States. Only Kerala, Punjab and Haryana had collected significant amounts from this source. The share of lotteries in Kerala's own NTR was 20.4 per cent in 2000-01 as against 8.6 per cent for all States. The share of forestry, in the case of Kerala (21.4 per cent) was the second highest among the major States. The share of receipts from 'industries' was only 3.2 per cent for Kerala as against 14.6 per cent for All States. Only six of the major States – Gujarat, Rajasthan, Madhya Pradesh, Bihar and Orissa- have substantial share of this head in their NTR. In the case of Orissa, it was as high as 52.6 per cent.

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[20] Government of Kerala, *Economic Review-2002-03*.

Table 17 gives the cost recovery ratios of different public services – social, economic and general services. The Table shows that aggregate cost recovery ratio calculated without including both revenue and expenditure relating to the heads - State lotteries, forestry and industries for Kerala was only 4.4 per cent as against 5.7 per cent for all States. The ratios for Kerala varied from 1.8 per cent for social services to 5.8 per cent for economic services. Paradoxically, cost recovery ratio was much higher (13.4 per cent) for General Services even excluding receipts from State lotteries (organs of State, administrative services, miscellaneous general services)than for economic services (5.8 per cent). The reasons for low cost recovery of public services in Kerala can be appreciated better if we also examine the pattern of public expenditure in the State. Social and Community services accounted for 35.3 per cent of the total revenue expenditure of Kerala in 2000-01 as against 17.1 per cent by economic services (other than Forestry and Industries). The general services (other than State lotteries) accounted for 9.8 per cent. The poor aggregate cost recovery ratio for the State is on account of the higher share of social services where the cost recovery was just 1.8 per cent. This ratio compares unfavourably with the average ratio for all States (2.2 per cent). Even in respect of economic services, the revenue cost recovery ratio was just 5.8 per cent for Kerala as against 9.0 per cent for All States. Kerala's rank with regard to cost recovery for all services after excluding the above three services was only tenth among the

fourteen major States. Only States like West Bengal, Bihar, Andhra Pradesh and Orissa lagged behind Kerala. Kerala's rank with respect to cost recovery ratios was sixth in the case of general services, tenth in social services and twelfth in economic services.

Table 17 also shows the movement of cost recovery ratios for different services during 1990-91, 1995-96 and 2000-01. The ratios for all services put together for Kerala, improved from 3.0 per cent in 1990-91 to 4.4 per cent in 2000-01. In all the three years, however, the aggregate ratios for Kerala were lower than those of All States. Taking different services separately there was a marked improvement in cost recovery from general services. But there was a decline in the recovery of revenue expenditure from both economic and social services. The principal reason for the decline in recovery from social services lies in the decline in cost recovery under education and allied services, which account for 62.6 per cent of the total expenditure under social services. A further disaggregation of the cost recovery ratio of education is presented in Table 18. The Table shows that cost recovery was not substantial in any sub segment of education. The recovery varied from 0.09 per cent in elementary education to 7.3 per cent in technical education. The cost recovery from medical education was considerably lower than that of technical education. Cost recovery in university and higher education was lower than that of secondary education during all but two years of the nineties.

The low rate of recovery from education was partly on account of the very large share of the expenditure on elementary education in the total expenditure on education (45.0 per cent). For understandable reasons, including the constitutional requirement of free education till the age of 14, the cost recovery rate in this sub-

[21] In the case of Kerala, for which the break-up of the data on revenue under industries is available, mineral concession fees, rents and royalties constituted 85 per cent of the total receipts under industries.

sector is insignificant. The share of secondary education in the total education expenditure of Kerala too was substantial (32.9 per cent) and the low cost recovery in this segment also contributed to the lower revenue receipts from the educational sector. ***In other words, the lower NTR from education is partly a price paid by the State for universalising school education, a national priority.*** The low cost recovery rate of university and higher education, medical education and to some extent technical education, which accounted for 14.6 per cent, 2.9 per cent and 4.2 per cent of the total educational expenditure was yet another causative factor for the low revenue cost recovery from the educational sector.

Low Non-Tax Revenue – The Reasons

Our discussion so far shows that the State's low level of non-tax revenue is on account of four factors. Firstly, the rates of recovery of revenue expenditure on public services are low (4.4 per cent in 2000-01). Secondly, the returns on capital outlay spent directly by the government are low (5.0 per cent). Thirdly, the dividends on investments by the government are poor (0.6 per cent). Fourthly, the interest recovered on loans extended by the government is very low (1.0 per cent).

The real reason for the low cost recovery from public services can be traced to the populist politics of the State. The State was trying to maintain a welfare State by charging low user charges for its public services. Such cheap provision of public services was financed in the past by tax revenue and borrowing. The strategy has now become unsustainable because of the slow growth of the economy, evasion of taxes, trade diversion and growing tax resistance. Limits to borrowing have also been reached by now.

There seems to be inadequate appreciation about the links between the present fiscal crisis of the State and the inefficiency of the PSUs. The State budget today is paying a very high price for maintaining its PSUs at their present State of inefficiency. Kerala has the largest number of PSUs among States in India. At the end of 2000-01, it had extended loans to the tune of Rs.3544 crores. Outstanding investments amounted to Rs.1883 crores. The major reason for the low amounts of dividends and interest received from these huge amounts of loans and investments lies in the poor performance of these public sector undertakings. Most of the interest in arrears is on account of public sector undertakings. In addition to extending loans directly, the State government had been guaranteeing the loans to these undertakings by the financial institutions. The government is expected to get guarantee fees, but in many cases these are in arrears. Many of the organizations in which the government had made investments or extended loans or issued guarantees are under liquidation or are on the verge of it.

The PSUs are maintained, despite their draining the budget, partly due to an old mindset which equates State capitalism with socialism. All PSUs are equated with public utilities irrespective of their products and services. And, the public utilities were not expected to generate surpluses as they were meant to fulfill some larger public purposes, often stated very vaguely. These well meaning notions, however, served not only to camouflage the subsidisation of the rich, but also the inefficiency and wastage, tolerated and very often encouraged by the political and bureaucratic leadership. The likelihood of job losses is often cited as the reason for not winding up or privatising these PSUs despite their making continuous losses. A recent study has shown that the losses incurred by some of these public sector undertakings are more than their expenses on personnel. This implies that if the companies are closed down and the workers paid their full salary until they retire or get alternate employment, the cost to the exchequer will be substantially less.[22] It appears that there are other hidden agendas in maintaining them. The top executive positions and memberships of the Boards are given to political leaders who cannot be accommodated in the cabinet or the legislature[23]. These undertakings are also a good means of patronage by giving employment and fixing contracts. But the State just cannot afford the luxury of retaining the loss making PSUs any longer.

The cooperative sector is another major source of drain from the State budget. Their contribution to the dividend income and the interest income of the government has been very low. The bureaucratic and political control of these bodies is the major reason for the inefficient functioning of these bodies leading to low revenue realisation by the government on its huge investments and loans.

The Scope for More Non-Tax Revenue

There is scope for increasing non-tax revenue through higher user charges as the rates for public services were fixed years back. These rates have not been revised though per capita income and the wage/salary levels had increased in the State. The beneficiaries may not be unwilling to pay higher rates as they are already incurring high costs to supplement the poor services of the government. They are also paying for the high transaction costs. But one of the prerequisites for increasing the cost recovery is that the quality of public services must improve substantially and the present high transaction costs reduced. Because of the poor quality of services and high transaction costs, large sections of the population have already opted out of public services in favour of private service providers (eg. in education, health care).

At the same time, the blanket increases in the prices of public services and the services of public utilities should not be allowed to be used for passing on to the public the costs of inefficiency in the government. In the present discussion, we have deliberately avoided the expression 'hidden subsidy' for the less than full recovery of costs because the expression is misleading in our view[24]. In non competitive situations as in the government, the costs are not the optimum. There is a good deal of waste and inefficiency in rendering public services, which are sought to be passed on to the users of these services in the name of reducing subsidies. The real beneficiaries of hidden subsidy, therefore, may not be the users of these services, but the wasteful service providers in the government.

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[22] M.N.V. Nair, *Finance Management in Government*, Public Affairs Forum, Thiruvananthapuram, 2003.

[23] For quite a long period, many of the PSUs were 'headless' and 'Boardless' as inter party and intra party squabbles among coalition partners for these plum positions could not yet be settled amicably.

[24] See, Government of India, Ministry of Finance, *Government Subsidies in India*, New Delhi, 1997.

Though there is further scope for increasing the non-tax revenue rates, the scope is not unlimited as is often made out by some of the votaries of fiscal reforms in the State. The State is being pushed by them from near total subsidisation to zero subsidisation on the pretext of fiscal crisis. There is a tendency to underplay the externalities of many of the public services. Equity is also not taken into consideration. The pendulum appears to be swinging from one extreme position to another

Any measure to raise additional resources through higher user charges requires fine calibration of pricing, taking into account the merit good character of the public service as also equity considerations. As in the case of taxes, prices of government services have to be graded and be fixed according to different income slabs. Without such calibration of prices, any move to effect blanket increase in prices of public services can lead to substantial loss of welfare. It may also undermine the achievements of the State in education, health care, food security etc. thus undermining the Kerala Model of development.

Expenditure Trends

It was seen from Table 6 that the growing fiscal crisis of the State during the second half of the nineties was more due to the failure of the State to mobilize both tax and non-tax resources. But, the expenditure management of the State cannot be totally absolved of the responsibility for the fiscal distress of the State. The growth rate in revenue expenditure was as high as 21.4 per cent in 1997-98 and 25.3 per cent in 1999-2000. It came down to 2.7 per cent in 2000-01 due to the severe expenditure compression forced on the government.

Table 19 shows the growth trends in different kinds of expenditures. The average growth rate in total expenditure (revenue +capital) declined from 15.5 per cent to 14.0 per cent between the first and the second halves of the nineties. But as in the case of revenue expenditure, the low growth rate in the second half of the nineties was on account of the steep decline in growth rate in 2000-01, from 21.6 per cent in 1999-2000 to 1.9 per cent. The average growth rate in capital expenditure came down steeply from 16.0 per cent in the first half to 4.3 per cent in the second half of the nineties. During the last three years, growth rates in capital expenditure were negative. This steep decline in growth rate of capital expenditure for Kerala may be contrasted with the increase, though marginal in the growth rates for All States. The development

expenditure shows a deceleration in the growth rate in the case of Kerala. In fact it was negative in 2000-01. But in the case of other States, it shows an improvement though only marginal. The biggest increase was recorded in the case of non-developmental expenditure during both the periods. This high growth rate in non-development expenditure is partly on account of the high growth rates in debt servicing (from 18.7 per cent to 19.9 per cent) and pensions. The average growth rates in non-plan expenditure during both periods was the same. The growth in plan expenditure came down drastically between the two periods (from 17.3 per cent to 11.7 per cent). The average growth rate in plan outlay came down from 21.8 per cent to 16.7 per cent.

Debt servicing accounted for one fifth of the total (Revenue + Capital) expenditure of Kerala in 2000-01. Besides, it is showing an almost steady growth trend from 1995-96 onwards. Debt servicing accounted for 69 per cent of the GFD in 2000-01. During three years of the nineties, (1991-92, 92-93, 93-94) debt servicing exceeded or equalled the GFD. These figures imply that the whole borrowing was less than adequate to service the past debt.

The percentage of interest payments in total revenue expenditure also shows an increase. The ratio rose from 12.1 per cent in 1990-91 to reach 19.0 per cent in 2000-01. Similar trends are visible in the case of All States too. But this ratio for Kerala was more than that of All States during every year of the nineties. Gross interest payments accounted for 58 per cent of GFD in 2000-01. The high and growing debt service obligations is on account of two factors. The first is the increase in volume of borrowings to finance the growing GFD. The second is the hardening of interest rates on government securities till 2001-02 following the financial sector reforms.

Table 20 shows the trends in salary and pension expenditure of the Kerala government. Salaries plus pensions as a percentage of revenue expenditure were coming down from 71.4 per cent in 1990-91 to 47.8 per cent in 1998-99. But it went up during the next two years largely due to the revision in salaries and pensions as a result of implementing the recommendations of the Fifth Pay Commission. Salaries plus pensions accounted for half of the total expenditure in 2000-01. It was more than half of the revenue expenditure. Salaries, pensions and interest payments representing three contractual obligations of the State accounted for 71 per cent of the revenue expenditure. It may be mentioned however that salaries include teaching grants to all aided private educational institutions. Salary payments on this item accounts for nearly one third of the total salary expenditure. The high share of the salary and pension components in the State government's expenditure is partly due to the high share of relatively more labour intensive social services, in the revenue expenditure of the State government. The share of these services, however is coming down.

From Table 20**,** it becomes clear that the share of pensions is steadily increasing in the revenue expenditure of the government. From 11.9 per cent in 1990-91, the share of pensions increased to 12.3 per cent in 1995-96 and to 16.2 per cent in 2000-01. It may be noted that the share of pensions in Kerala is almost double that of All States. It may be noted further that the amount of annual pensions is considerably more than the annual revenue expenditure on all administrative services put together. This may partly be due to the high life expectancy, early age of retirement and liberal commutation provisions.

Need for Expenditure Management

Fiscal reforms must target both expenditure management and resource mobilisation simultaneously. The expenditure management of the State governments had been mostly ad hoc, leading to across the board cuts in expenditure. This may be seen in the very abrupt and drastic compression of every type of expenditure in 2000-01 (Table 19). This has been rendering government expenditure increasingly unproductive. In the present context, what is called for is a planned expenditure reduction. This calls for redefining the role of the State governments, taking into account the Indian federal system and the ongoing liberalization process. In the light of this redefinition, expenditure priorities will have to be determined afresh and some of the unproductive activities have to be abandoned altogether. This is necessary to strengthen the State's capacity to perform its core functions including its regulatory functions. Under the Indian federal system, the responsibility for social sector and welfare expenditure lies mostly with the State governments. And it is in these social sectors that market failures and market imperfections can lead to inadequate allocation of resources and inequitable outcomes. The State certainly will have to play a role in economic services. But it has to be restricted to such areas where private sector is unlikely to enter or is less efficient. But just the opposite seems to be happening in the State in the name of economic reforms and fiscal reforms. The State is getting more and more involved in economic services as may be seen from the increasing share of economic services in the expenditure budget. The State's involvement in loss making PSUs is not coming down. At the same time, the share of State's expenditure on social services, particularly on education is being brought down drastically. The share of education in State's expenditure has been coming down from 35.1 per cent in 1960-61 to 22.5 per cent in 2001-02.[25] The present share is lower than the share of education in the budget of erstwhile Travancore Cochin State in 1954-55. This has led to commercialization of education limiting access to the rich. This is also happening in the healthcare sector.

Fiscal reforms is an area where public finance and public administration meet. We cannot have fiscal reforms in India without reengineering the government and implementing budgetary and administrative reforms. As everyone dealing with the government knows, there are a large number of restrictive labour practices in the government. The government machinery is creaking and the systems and procedures are archaic. This has led to the low productivity of staff and the poor quality of public services. In fact, expenditure management must bestow equal or more attention to increasing expenditure productivity than to expenditure reduction. The capacity of the State to service its debt to cover the GFD depends on the productivity of expenditure, both revenue and capital.

The Irrelevance of Budgetary Classifications

Some of the budget classifications and the practice of giving preference to one category over the other stand in the way of increasing productivity of public expenditure. The distinction between capital and revenue expenditure, priority being given to the first category is one such classification. As pointed out by Gulati in 1993, "distinguishing between revenue account and capital account in government spending may not be as helpful as between the purposes for which government spending, be it on revenue or capital account is to be

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[25] *Financing Secondary Education in Kerala*, Working Paper No.8, Centre for Socio-economic and Environmental Studies, Kochi, 2003.

incurred."[26] The assumption that the productivity of revenue expenditure is less than that of capital expenditure is not based on any empirical evidence as was seen by us earlier. There is no evidence to suggest that the productivity of a new capital asset is more than the productivity of revenue expenditure on maintenance of the assets acquired earlier. Similarly, one cannot assert that the long-term productivity to the economy of the expenditure on literacy and primary education, which will be largely on revenue account, is lower than the expenditure on an irrigation project, mostly on capital account. The capital revenue composition of expenditure varies according to the sectors in which they are made. For instance, primary education will have larger revenue component than expenditure on higher education or on industry. Many of the sectors where the revenue content in expenditure is higher, like health, education, policing etc. are in the State List under the Indian constitution. The sectoral priorities for expenditure by states should vary according to their development status and priorities. There cannot be a uniform prescription regarding the proportion of revenue expenditure in the total expenditure without taking into account the sectoral composition of expenditure. The total productivity of public expenditure will be more if the right proportion of revenue and capital expenditure is incurred.

The plan-non plan distinction giving priority to the former is another classification leading to waste in government expenditure. It is not often realized that the non-plan is not synonymous with non-developmental. To quote Gulati again "……even the distinction between the plan and non-plan spending is not very useful because a good part of non-plan spending is meant for the maintenance and running of the socio-economic infrastructure on which rests the whole edifice of the country's current economic growth."[27]

The classification of expenditure into developmental and non-developmental with priority attached to the former category has also led to under funding of those essential services that can be best provided by the governments. As noted earlier, bulk of what is classified as non-developmental expenditure is on account of two contractual obligations viz., interest and pensions, which account for almost a quarter of the revenue expenditure. The other components of non-developmental expenditure include those on such crucial public services like fiscal services, organs of state, administrative services like policing, judiciary, jails, revenue administration, etc. But these services account for only 13 percent of the total revenue expenditure. In the quest for 'development', the importance of these indispensable services is often underestimated. It is often overlooked that it is the provision of these basic services by the State which is the basis of the social compact between the people and the State. It is through these services that the state is discharging not only its core functions like policing, administration of justice etc., but also its regulatory functions. The role of these services in providing the most basic infrastructure for development is not often understood. The enforcement of law and order, speedy administration of justice, timely enforcement of contracts etc. are crucial not only for the welfare of the citizens but also for economic growth in a market driven economy. But unfortunately, the under provisioning of these services has led to low quality and effectiveness of these basic services. This has also led to higher transaction costs for the users of these public services. The under funding of these services has led to strange situations in Kerala where the police were immoblised for want of petrol for their vehicles. We have also got increasing

[26] Gulati I.S, "Tackling the Growing Burden of Public Debt", *Economic and Political Weekly (EPW)*, May 1, 1993. See also Gulati I. S. "Reducing the Fiscal Deficit" *EPW*, July 20, 1991
[27] Ibid

evidence of *de facto* 'privatisation' of policing and judicial functions, in view of the slow moving nature of the ill equipped government machinery. We have the strange phenomenon of the most crucial administrative departments performing the most basic, core government functions remaining the least modernized on account of shortage of funds.

From the discussion so far, it comes out very clearly that the status quo cannot continue any further and fiscal reforms brook no delay. But any knee jerk reaction can lead to more harm than good both to the reform process and to the State's development. It appears that fiscal reforms in Kerala are caught between two antique ideological positions. Ideological blinkers of those who argue implicitly for the status quo make them equate socialism with public sector and across the board subsidisation of public services with a Welfare State. They are oblivious of the deterioration in quality of public services, in the absence of adequate financial provisioning, which affects the poor more than the rich. Pitted against the *status quoists* are the new champions of fiscal reforms who appear to have a delusion of going back to the vintage model of laissez faire and seem to be unaware of the large role of the State even in a market driven economy. They seem to be unclear about the objectives of reforms. The objective of reform is not to undermine the interest of large sections of the population by pricing them out of public services as well as the services of public utilities, but to sustain their interest in such services by improving their quality and reducing the hidden transaction costs. Fiscal reforms should not lead to undermining of achievements of Kerala Model of Development. In our view, the Kerala Model and its achievements are still laudable. The only issue is its sustainability in the absence of fiscal reforms. Fiscal reforms should aim at sustaining the Kerala Model. Reforms should not lead to throwing the baby with the bath water.