KERALA
PUBLIC EXPENDITURE
REVIEW COMMITTEE

First Report

May 2006

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REVIEW COMMITTEE

[Constituted as per Gazette Notification No.17950/FRC-2/04/Fin dated 25-11-2005
(S.R.O. No.1033/2005) as prescribed under Section 6 of the
Kerala Fiscal Responsibility Act, 2003 (29 of 2003)]

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Foreword and Acknowledgements

We present the First Report of the Public Expenditure Review Committee, constituted under section 6 of the Kerala Fiscal Responsibility Act of 2003 (Act 29 of 2003). Since the Committee was notified only on 25 November 2005, the annual review report due in the month of November each year, by the Rules pertaining to the Committee, had necessarily to be postponed. This report is being submitted by end-May 2006, in time for the budget exercises of the new Ministry that will take charge after the elections.

One Member of the Committee Dr. K.P. Kannan, was indisposed for an extended period, and therefore could not join in the preparation of this report.

The Committee wishes to thank Mr. K. Jose Cyriac, Principal Secretary (Finance), Government of Kerala, for his unstinting cooperation to the Committee. Mr. R. Venkitaramanan, Joint Secretary, Finance Department, unfailingly provided all the documentation and data required. Other officials of the Kerala State Government who provided valuable insights in the course of meetings with them during 14-17 March were:

Dr. Alok Sheel	Secretary (Finance- Resources)
Smt. Ishita Roy	Special Secretary (Finance- Expenditure)
Smt. Lida Jacob	Secretary (General Education)
Shri P.J.Thomas	Additional Chief Secretary (Higher Education)
Shri Gyanesh Kumar	Secretary (Public Works)
Dr.Viswas Mehta	Secretary (Health and Family Welfare)
Dr.Rajan Khobragade	Additional Secretary (Health)
Smt.Lizzie Jacob	Additional Chief Secretary (Planning&Economic Affairs, Power)
Shri S.M. Vijayanand	Principal Secretary (Local Self Government- Rural)
Shri K. V. Rabindran Nair	Former Chief Secretary, Government of Kerala and Chairman, Third State Finance Commission
Shri V.Ramachandran	Former Chief Secretary, Government of Kerala, and former Vice- Chairman, State Planning Board

DR. N. J. KURIAN,
MEMBER.

DR. INDIRA RAJARAMAN,
CHAIRPERSON.

1. INTRODUCTION

The Public Expenditure Review Committee was constituted under section 6 of the Kerala Fiscal Responsibility Act of 2003 (Act 29 of 2003). Sections 8 and 9 of the Rules as notified on 1 March 2005 (SRO No. 216/2005) pertaining to the terms and conditions of the Committee require an Annual Review Report in the month of November each year following the constitution of the Committee.

Since the constitution of the Public Expenditure Review Committee was notified only on 25 November 2005, clearly that requirement could not be met in the financial year 2005-06. The Committee therefore decided to submit its report by end-May 2006, in time for the budget exercises of the new Ministry which will take charge after the elections.

The Rules on the required contents of the review report in Section 9 (listed in Appendix I), call for the Committee to focus on the deviation from the fiscal target during the previous year. The original Kerala Act extended from 1 April 2003 to 31 March 2007. At the time of writing of the present report, audited actual fiscal figures were available for the years 2003-04 and 2004-05. Accordingly, those are the two years of focus for the present report. However, since revised estimates for 2005-06, and budget estimates for 2006-07 were also available at the time of writing, these will be examined as well, keeping in mind the caveat that eventual actuals may depart quite considerably even from revised estimates.

The original Kerala Act of 2003 contained only a commitment to fiscal targets in the terminal year of the correction horizon, with no annual path commitment towards that eventual target. The subsequent amendment to the Rules notified on 19 May 2005 (vide SRO No. 516/2005) introduced targets for the penultimate year 2005-06 in addition. But for the year 2004-2005, which is the year under examination in this report, any assessment can only be done by pro-rating the annual fiscal correction required with respect to the terminal year.

The Kerala Act is to be amended to extend the correction horizon by two years, to 2008-09, as permissible under the conditionalities accompanying the interest rate concession and debt consolidation offer of the Twelfth Finance Commission. Thus, a revenue deficit of zero need now be reached only in 2008-09 rather than by 2006-07. This therefore eases the fiscal correction as originally envisioned under the Act. Further, the post-TFC target for the fiscal deficit at 3 percent of GSDP is actually more lenient than the 2 percent of GSDP prescribed under the Kerala Act, and here again there is a permissible extension of the eventual target year to 2008-09.

The assessment of deviations from targets in the sections that follow will therefore keep these factors in mind.

Section 2 of this report looks into the deviation from targets in respect of the reported measures of fiscal imbalance, and will assess the fiscal correction achieved in 2003-04 and 2004-05 relative to 2002-03, the pre-FRA year of the fiscal correction period, which serves as the base year for assessment purposes. The section first deals with revenue deficits, overall and primary, and then takes up the overall and primary fiscal deficits.

Section 3 goes into some issues regarding the assignment of expenditures to the revenue and capital accounts. There appear to be some legitimate reasons for reclassification of some of these, so that a better idea is obtainable of the true revenue and overall fiscal deficits. The ultimate purpose of having separate targets for revenue and fiscal deficits in FRA legislation is to have separate and more stringent controls for revenue expenditure, and thereby to provide a larger permissible margin for growth-promoting capital expenditure. This purpose is defeated if capital expenditures are classified under the revenue head.

Section 4 will do a more extended assessment of the three years since the FRA, 2003-06, relative to the four-year period immediately preceding the Act, 1999-03, for revenue receipts in own tax revenues, non tax revenues and transfers from the Centre.

Section 5 examines the several constituents of revenue expenditure and of capital expenditure, once again for 2003-06 relative to 1999-03.

Section 6 will probe deeper into the effectiveness of expenditures in two large sectoral claimants, education and health.

Section 7 will examine the debt stock, debt servicing, off-budget borrowings, and guarantees.

Section 8 presents concluding numbered recommendations.

2. OVERALL FISCAL IMBALANCE TARGETS

Revenue Deficit (RD) and Primary Revenue Deficit (PRD)

The changes in each of the years 2003-04 and 2004-05, relative to the year preceding, in the major indicators of fiscal imbalance, the revenue deficit (RD), fiscal deficit (FD) and the primary deficit (PD), are shown in table 2.1, along with the revised estimates for 2005-06. The budget estimates for 2006-07 are shown in table 2.2.

The standard with respect to which performance is to be assessed must first be established. In the absence of any target for the year 2004-05, already alluded to in the Introduction, the required annual reduction in the RD, pro-rated from its pre-FRA level of 5.09 percent of GSDP in 2002-03, to a target of zero in 2006-07, works out to 1.27 percent. However, if the Kerala Act is amended to target a zero RD in the TFC terminal year of 2008-09, as is likely, that yields a lower required annual reduction by 0.85 percent of GSDP.

Against the amended requirement, the actual decline in the RD of 1.01 percentage points in 2003-04 relative to 2002-03 is well above requirement. However, the decline in the RD by 0.43 percentage points in 2004-05 relative to 2003-04 falls short, but is at least in the right direction. Taking the two years together, the decline by 1.44 percent of GSDP is somewhat lower than the 1.70 percent required.

From the evidence of the revised estimates (RE) for 2005-06, this correction direction appears to have been lost thereafter. These revised estimates however may be considerably revised further, so no judgement can be formed regarding the actuals for the year. The budgeted RD in the 2006-07 stands at 3.75 percent of GSDP. To reduce this to zero in 2008-09 requires a reduction by approximately 1.88 percent of GSDP in each of the years 2007-08 and 2008-09. That is a tall order. However, too much should not perhaps be made of the budget estimates for 2006-07, since the budget estimates are not a good pointer to the eventual actuals (see table 2.2 and accompanying discussion).

The momentum of correction in the RD visible in the first two years of the FRA has very clearly been lost, perhaps irretrievably. What is commendable is that the decline in the RD in those two years took place at a time when the interest outflow increased by nearly Rs.300 crore every year. Thus, the primary revenue deficit was reduced very sharply to Rs. 352 crore in 2003-04, and further to a negligible 56 crore in 2004-05, through a sharp compression in non-interest revenue expenditure. By the revised estimates for 2005-06, the primary revenue deficit reversed direction in 2005-06, showing that the reversal of correction in the RD was not due to some unforeseen outflow of interest payments. However, revised estimates are subject to correction.

Table 2.1 also shows that the decline in the revenue deficit over the first two years of the FRA was achieved as the outcome of a higher increase in total revenue, by 11.07 percent and 14.26 percent respectively, and a lower increase in revenue expenditure, by 5 percent and 10.8 percent respectively. The revenue effort by the revised estimate for 2005-06 was actually even better, recording a 23 percent increase, but it was wiped out by an equivalent percent rise (and therefore a larger absolute rise) in revenue expenditure.

Table 2.2 presents the budget estimates for 2004-05 and 2005-06. The RD was budgeted to increase in both years by 2 and 0.4 percentage of GSDP respectively, relative to the year preceding. These budget estimates were seriously out of line with the monotonic reduction implicit in the Act, and do not suggest that the government took the Act seriously, at least in its budgetary provisions. Although the actuals for 2004-05 show imbalances well below what was budgeted, the issue of fiscal marksmanship is an important one. Large disparities between budget estimates and actuals reduce the value of the annual budget as an accurate predictor of revenue and expenditure for the forthcoming year.

Fiscal Deficit (FD) and Primary Fiscal Deficit (PFD)

The required annual reduction in the FD, pro-rated from the pre-FRA level of 5.53 in 2002-03, to the target of two percent in 2006-07, works out to 0.88 percentage points of GSDP. Once again, with the probable amendment of the target to 3 percent of GSDP by 2008-09, the required reduction works out to 0.42 percentage points per year.

Against this benchmark, the FD actually rose in 2003-04 by 0.61 percent, but was reduced by 1.71 percent in 2004-05, thus more than compensating for the rise in the FD in 2003-04. Thus the pattern of correction in the first two years of the FRA has been sharp correction in the RD in 2003-04, the first year, accompanied by a rise in the FD, followed in 2004-05, the second year, by a less sharp cut in the RD, with a very sharp cut in the FD. The RD as a percent of FD correspondingly fell from 83 to 66 percent in 2003-04, but then rose back up to 82 percent in 2004-05.

From this pattern of correction, it is clear that capital expenditure was cut very sharply in 2004-05. The figures for capital expenditure in table 2.1 will differ from the officially reported total because the figure here nets out loan recovery from gross loans and advances to obtain the (net) lending component. There needs to be a consistent distinction in the official figure between capital outlay (direct expenditure), capital expenditure (outlay plus net loans), and capital disbursement (outlay plus gross loans).

Within capital expenditure, the net lending component of capital expenditure shows wild fluctuations from year to year. The very large net lending in 2003-04 was because of a single large loan of Rs.1149 crore to the Kerala State Electricity Board, towards purchase of Power Bonds of the National Thermal Power Corporation, in lieu of dues owed by KSEB to NTPC. The large increase in 2005-06 is on account of an on-lent loan from the Japan Bank for International Co-operation (JBIC) of Rs. 450 crore to the Kerala Water Authority. The KWA also is given non-plan grants to cover its operating losses, on account of non-payment by panchayats of water bills. Likewise, KWA is in default of payments owed to the KSEB. There is an immediate need for a one-time sorting out of outstanding dues of public sector agencies of the state, along the lines of what was done in the NTPC case, accompanied by withholding of annual grants to panchayats in respect of payments due to KWA. With effect from 2005-06, fifty percent of dues to the KWA are payable to the KSEB. These are all steps in the right direction. Intra-governmental dues need to be immediately sorted out along these lines.

The direct capital outlay has remained more or less steady at 0.7 percent of GSDP, in all three years of the period 2003-06. It is projected to rise to over 1 percent of GSDP in 2006-07, but previous departures from budgeted estimates do not encourage confidence in the budget estimates.

Infrastructure in Kerala state is seriously underprovided in some sectors such as drainage and waste water disposal. This is leading to sewage contamination of well water used for drinking purposes, and therefore to the spread of avoidable diseases. There is also an acute drinking water shortage. A holistic plan for a solution to the drinking water and sanitation requirements of the state is called for. The Kerala Rural Water Supply and Sanitation Project (Jalanidhi), an integrated project for improvement of the quality of rural water supply, implemented through local beneficiary groups, is an excellent first step in the right direction. Other critically needed infrastructure is wider two-laned highways, with road dividers, to reduce the very high accident rate in the state

The primary fiscal deficit declined from 2.5 percent of GSDP to under 1 percent in 2004-05, but went back up again to 1.76 percent in 2005-06, and is budgeted to increase further to 1.91 percent in 2006-07. The rise in the primary fiscal deficit by the revised estimates for 2005-06, by 0.92 percent of GSDP, is higher than the rise in the gross fiscal deficit, by 0.83 percent, showing that there was a rise in non-interest expenditure. The budget estimates for 2006-07 show that both will rise in tandem, which shows intent to stabilise the share of non-interest in total expenditure, which is at least a good beginning.

To conclude, against the backdrop of an absolute reduction in the primary revenue deficit to Rs. 352 crore in 2003-04, and further to a negligible Rs. 56 crore in 2004-05, through a sharp compression in non-interest revenue expenditure, the primary fiscal deficit in 2003-04 rose in absolute terms, driven by a major loan to KSEB for purchase of Power Bonds of NTPC. The primary fiscal deficit fell thereafter in 2004-05, again driven by a reduction in net loans. Capital outlay has been allowed to increase more generously in 2005-06 and 2006-07, but net lending has also gone up after having been slashed in 2004-05. These issues will be explored in greater detail in the next section.

TABLE 2.1

OVERALL FISCAL INDICATORS FOR FRA PERIOD

	Actuals			*Diff (percent/GSDP)*		R.E.	*Diff (percent/ GSDP)*
	2002-03	2003-04	2004-05	*03-04A/ 02-03A*	*04-05A/ 03-04A*	2005-06	*05-06RE/ 04-05A*
Revenue Deficit in Rs. Cr.	4119	3680	3669			4494	
RD/GSDP (%)	**(5.09)**	**(4.08)**	**(3.65)**	***(-1.01)***	***(-0.43)***	**(4.03)**	***(0.38)***
Fiscal Deficit in Rs. cr.	4990	5539	4452			5873	
FD/GSDP (%)	**(5.53)**	**(6.14)**	**(4.43)**	***(0.61)***	***(-1.71)***	**(5.26)**	***(0.83)***
RD/FD (%)	**(82.54)**	**(66.44)**	**(82.41)**	***(-16.09)***	***(15.97)***	**(76.52)**	***(-5.89)***
Primary Revenue Deficit in Rs.cr	1172	352	56			583	
PRD/GSDP (%)	**(1.45)**	**(0.39)**	**(0.06)**	***(1.06)***	***(-0.33)***	**(0.52)**	***(0.47)***
Primary Fiscal Deficit in Rs. cr.	2043	2211	839			1961	
PFD/GSDP (%)	**(2.53)**	**(2.45)**	**(0.83)**	***(-0.08)***	***(-1.62)***	**(1.76)**	***(0.92)***
Cap. Exp./GSDP (%)	**(1.08)**	**(2.06)**	**(0.78)**	***(0.98)***	***(-1.28)***	**(1.24)**	***(0.46)***
Direct Capital Outlay/GSDP (%)	**(0.86)**	**(0.71)**	**(0.68)**	***(-0.15)***	***(-0.03)***	**(0.72)**	***(0.04)***
GSDP in Rs. cr.	80844	90172	100531	*(11.54)*	*(11.49)*	111633	*(11.04)*
	Actuals			***Change(percent)***		**R.E.**	***Change (percent)***
	2002-03	**2003-04**	**2004-05**	***03-04A/ 02-03A***	***04-05A/ 03-04A***	**2005-06**	***05-06RE/ 04-05A***
Revenue Account in Rs.cr.							
Revenue receipts	10637	11815	13500	*(11.07)*	*(14.26)*	16596	*(22.93)*
Revenue expenditure	14756	15496	17169	*(5.01)*	*(10.80)*	21090	*(22.83)*
Capital Expenditure in Rs. cr.	871	1859	783	*(113.31)*	*(-57.88)*	1379	*(76.13)*
Direct capital outlay	699	640	682	*(-8.44)*	*(6.57)*	804	*(17.89)*
Net loan disbursement	173	1219	101	*(605.79)*	*(-91.69)*	575	*(467.78)*
Total Expenditure in Rs. cr.	15627	17354	17952	*(11.05)*	***(3.45)***	22469	*(25.16)*
of which interest in Rs. cr.	2947	3328	3613	*(12.94)*	***(8.56)***	3911	*(8.29)*

Notes:—Capital expenditure is obtained from the sum of direct capital outlay, and net loan disbursements (gross disbursements minus loans recoveries).

TABLE 2.2

BUDGETED FISCAL INDICATORS FOR FRA PERIOD

	Budget est.	*Diff (%/GSDP)*	*Budget est.*	*Diff (%/GSDP)*	*Budget est.*	*Diff (%/GSDP)*
	2004-05	*04-05BE/ 03-04A*	*2005-06*	*05-06BE/ 04-05A*	*2006-07*	*06-07BE/ 05-06RE*
Revenue Deficit in Rs. cr.	6093		4072		4732	
RD/GSDP (%)	**(6.06)**	***(1.98)***	**(4.05)**	***(0.40)***	**(3.75)**	***(-0.27)***
Fiscal Deficit in Rs. cr.	5343		5171		6835	
FD/GSDP (%)	**(5.31)**	*(-0.83)*	**(5.14)**	*(0.72)*	**(5.42)**	***(0.16)***
Direct Capital Outlay/GSDP (%)	**(0.57)**	*(-0.14)*	**(0.53)**	*(-0.15)*	**(1.12)**	***(0.40)***

Notes:—Capital expenditure is obtained from the sum of direct capital outlay, and net loan disbursements (gross disbursements minus loans recoveries).

3. ADJUSTMENTS REQUIRED TO REVENUE DEFICIT AND CAPITAL OUTLAY FIGURES

The reported fiscal deficit understates true borrowing because of unpaid bills, the extent of which, for the Public Works, Irrigation and Harbour Engineering Departments together, is estimated at around Rs.1500 crore at the time of writing. These estimates are not reported anywhere in the budget documents, although they would emerge routinely from accrual accounts. Within the present system of cash accounting, the difference between the opening and closing stocks of unpaid dues can be added on to obtain a truer picture of the change in liabilities of the Government in the course of the fiscal year. That adjustment has not been done here.

Three other types of adjustments that emerged as clearly necessary from discussions with State Government officials merely alter the relative magnitude of the revenue deficits, but have no impact on the fiscal deficit.

1. It is estimated that around 50 per cent of the Public Works Department (PWD) expenditures on the revenue account should really be characterized as capital expenditure, since about half of expenditure of maintenance of roads for example is indistinguishable from expenditure on laying a new road. PWD maintenance of national highways is recorded as revenue expenditure. The department also maintains State Highways, major district roads and some urban roads.

2. The annual devolution to local bodies is an expenditure recorded entirely on the revenue account, because of the ruling by the Comptroller and Auditor General that a grant cannot be recorded on the capital account, but around 50 per cent of this again is estimated to go

towards capital outlays. By the recommendation of the third State Finance Commission of Kerala, the devolution will henceforth go entirely as a non-plan grant, which is prescribed in absolute terms, and from which local bodies are expected to fund Plan expenditures. With this, the capital outlay has been structurally included in the revenue account grant going towards Panchayats, laying therefore the grounds for a wholly justified revision of reported revenue and fiscal deficits. In order not to affect year-to-year comparability, this adjustment has to be done for all years of the FRA period, and also for the base pre-FRA year.

3. Assistance from externally aided projects, such as the Kerala State Transport Project, for instance, was entirely recorded on the revenue account. This is now to be split into capital and revenue with effect from 2006-07. If this is not also done for prior years, it will affect comparability before and after 2006-07.

Table 3.1 generates adjusted revenue and fiscal deficit estimates for the years 2003-04 and 2004-05, the first two years of the FRA, after adjusting only for the first and second points above. The adjusted revenue deficit is lower than the reported figure by approximately 1.2 percentage points of GSDP. Starting from 3.88 per cent of GSDP, the yearly required reduction in the adjusted RD is 0.65 per cent of GSDP. The achieved reduction over two years is 1.42 per cent, somewhat higher than the 1.30 per cent required. Thus, the generation of the adjusted revenue deficit alters the conclusions drawn earlier about the failure to measure up fully to the revenue account correction required. The adjustment does make a difference. There is therefore a case for further finetuning the approximate correction made here, so that an accurate figure is possible of the true revenue deficit.

By the same token, the capital outlay goes up by the same estimated 1.2 per cent of GSDP, as shown in the table. This yields an adjusted budgetary capital outlay in the neighbourhood of 2 per cent of GSDP, as against the reported budgetary outlay of 0.7 per cent of GSDP.

There is a strong case for amending the Kerala FRA so as to target the adjusted RD along these lines, and for a case to be made to the Union Finance Ministry to allow such an amendment for fulfillment of the TFC conditionalities.

Projects funded under the Member of Parliament Local Area Development Scheme (MPLADS) and the equivalent scheme for Members of the Legislature (SDFMLA) add a further element of public funding of capital outlay at local level. These are allocated at the discretion of the MP or MLA in question, unlike Centrally Sponsored Schemes, under which funds whether for capital outlays or employment generation flow uniformly to all local bodies. Large episodic receipts of this kind go into creation of hospitals and other infrastructure unmatched to the disease burden or other local needs, and with low utilization rates. A commendable recent decision by the State Government not to lend salary support for operation of infrastructure created by local bodies through funding from either these schemes or general grants from the State, will put an end to the creation of unviable infrastructure.

A further augmented capital outlay, including capital outlays funded under the MPLAD and SDF for MLA schemes, would yield a useful handle on the aggregate publicly funded capital outlay in the state, in addition to outlays funded directly by the Central Government.

TABLE 3.1

UNADJUSTED AND ADJUSTED RD AND FD: 2002-05

Rs. Crore	*Actuals*			*Diff percent/ GSDP*	*Diff percent/ GSDP*
	2002-03	*2003-04*	*2004-05*	*03-04A/ 02-03A*	*04-05A/ 03-04A*
RD	4119	3680	3669		
Rev exp. on public works, roads and bridges	510	487	600		
of which est. cap. component	255	243	300		
Devolution to local bodies	1458	1731	1783		
of which est. cap. component	729	866	892		
Adjusted RD	3135	2572	2478		
Capital outlay in Rs. Cr.	699	640	682		
Adjusted capital outlay	1683	1749	1873		
(Percent/GSDP)					
RD/GSDP	**(5.09)**	**(4.08)**	**(3.65)**	***(-1.01)***	***(-0.43)***
Adj RD/GSDP	**(3.88)**	**(2.85)**	**(2.46)**	***(-1.03)***	***(-0.39)***
Cap outlay/GSDP	**(0.86)**	**(0.71)**	**(0.68)**	***(-0.15)***	***(-0.03)***
Adj capital outlay/GSDP	**(2.08)**	**(1.94)**	**(1.86)**	***(-0.14)***	***(-0.08)***

Finally, the institutional mechanism for estimating the internal rate of return on capital investment projects needs to be strengthened, so that projects can be ranked and prioritized. The need for this is especially acute among local bodies. Funding from MPLADS and SDFMLA is allocated at the discretion of the MP or MLA in question. Large episodic receipts of this kind go into creation of hospitals and other infrastructure unmatched to the disease burden or other local needs, and with low utilization rates.

Lapsing of funds is critical for expenditure incentives to be built into the system. However, the lapsing cycle for capital outlays needs to be matched to the time-profile of projects. The stringent procedures governing capital expenditures make it difficult for expenditures to conform to a single-year lapsability structure. In Kerala where the density of roads is high, the need is for two-laning of pre-existing roads, and building of road dividers, so that the very high accident rate can be brought down. This calls for extended initial time for land acquisition. These delays need to be responsibly estimated and built into the lapsability structure up-front.

4. REVENUE RECEIPTS

The previous sections carried an exclusive focus on the post-FRA years, 2003-04 and 2004-05, relative to the year preceding. Table 4.1 extends the focus to a broader span of years starting from 1999-2000 as the base. The budget estimates for 2006-07 are not included only because, as pointed out in section 2, they are not a reliable indicator of realized actuals.

Total revenue receipts (TRR) over the first two years 2003-05 of the FRA period grew at 12.7 per cent on average, higher than the annual average of 10.2 per cent achieved over the years 2000-03.

However, the constituents of total revenue show that this improvement was driven by higher transfers from the Centre, aggregating across tax shares and grants, which increased annually at 18.4 per cent over 2003-05, as against a mere 6.2 per cent annual rate of increase over 2000-03.

From a fiscal correction perspective, what matters is the performance of the State's own revenues. Own tax revenue registered a **lower** annual rate of increase, at 10.8 per cent in the first two years of the FRA period, than the annual increase of 12 per cent over 2000-03. The buoyancy of own tax revenue (obtained through simple division of the compound annual growth rate of revenue by that for nominal GSDP, rather than through econometric estimation) came down to 0.9, as against 1.3 per cent in the period 2000-03. It is possible that the higher revenue flow from the Centre may have caused the drop in own tax effort, contrary to what is termed the flypaper effect in the literature.

The year 2004-05 concludes for Central transfers the period mandated by the Eleventh Finance Commission. The year 2005-06 is the first in the period mandated by the Twelfth Finance Commission (TFC). There was therefore a leap in the rate of growth of Central transfers that year, because of the more generous provision for States in general, notwithstanding the reduced share of Kerala in Central taxes, because of a compensating deficit grant. This will not translate into a corresponding increase in the year to year growth in Central transfers during the TFC period. The state should not in any case rely on Central transfers to provide the revenue support for the achievements of the targets of the FRA.

Fiscal restructuring necessarily implies better effort on all fiscal handles under the control of the State. The buoyancy of own tax revenues should immediately be raised. The only good feature of own tax revenue performance in the FRA period is that the annual growth has been more uniform than in the period 2000-03, when it was more volatile.

Non-tax revenue did slightly better in annual average growth terms in 2003-05 than in 2000-03, but the buoyancy was lower nevertheless. In this case, the year-to-year growth has remained as volatile as in earlier years.

To conclude, the State has to enhance its own revenue effort, which currently adds up to around Rs.11,000 crore, amounting to 10 per cent of GSDP. Of this, the own tax component has not risen above a steady 9 per cent of GSDP in the three years going up to 2004-05. Although own taxes are at about the same percentage of GSDP in the other Southern States, it has to be remembered that Kerala is a remittance-receiving State, from a large diaspora. These remittances do not get recorded in the GSDP figures at State Level, which are at factor cost. Since taxes are levied on expenditure, which is funded out of household disposable income inclusive of external remittances, the Kerala own tax revenue to GSDP ratio should be higher than for other states not receiving remittance income.

The State switched over to a VAT along with the majority of other States on 1 April 2005. However, the VAT does not apply to four items which together contribute roughly half of the total sales tax revenue of the State. The four are petroleum products, sales tax on liquor, aviation turbine fuel, and entry tax. There has been a drop in revenue with the introduction of the VAT, but the Centre has underwritten a guaranteed increase in revenue at 17.94 percent with respect to the previous year in respect of items subject to the VAT.

TABLE 4.1

REVENUE RECEIPTS

Revenue Receipts	*Pre-FRA Period*				*Average 2000-03*	*FRA Period*			
	Actual					*Actual*		*Average 2003-05*	*R.E.*
	1999-00	*2000-01*	*2001-02*	*2002-03*		*2003-04*	*2004-05*		*2005-06*
Total Revenue Receipts in Rs. Cr.	7944	8731	9056	10637		11815	13500		16596
Growth rate (%)		(9.9)	(3.7)	(17.5)	**(10.2)**	(11.1)	(14.3)	**(12.7)**	(22.9)
TRR/GSDP (%)	(12.7)	(12.5)	(12.5)	(13.2)		(13.1)	(13.4)		(14.9)
Buoyancy		(0.9)	(1.0)	(1.5)	**(1.1)**	(1.0)	(1.2)	**(1.1)**	(2.1)
State's Own Taxes in Rs. Cr.	5194	5870	5923	7303		8089	8964		10255
Growth rate (%)		(13.0)	(0.9)	(23.3)	**(12.0)**	(10.8)	(10.8)	**(10.8)**	(14.4)
Own taxes/GSDP (%)	(8.3)	(8.4)	(8.2)	(9.0)		(9.0)	(8.9)		(9.2)
Buoyancy		(1.1)	(0.2)	(2.0)	**(1.3)**	(0.9)	(0.9)	**(0.9)**	(1.3)
State's Non Tax in Rs. Cr.	533	659	543	681		807	819		889
Growth rate (%)		(23.7)	(-17.6)	(25.4)	**(8.5)**	(18.5)	(1.5)	**(9.6)**	(8.5)
Own non-tax/GSDP (%)		(0.9)	(0.8)	(0.8)		(0.9)	(0.8)		(0.8)
Buoyancy		(2.0)	(-4.7)	(2.2)	**(1.0)**	(1.6)	(0.1)	**(0.8)**	(0.8)
Central Transfers in Rs. Cr.	2218	2202	2590	2654		2920	3718		5452
Growth rate (%)		(-0.7)	(17.6)	(2.5)	**(6.2)**	(10.0)	(27.3)	**(18.4)**	(46.6)
GSDP in Rs. Cr.	62520	69770	72349	80844		90172	100531		111633
Growth rate (%)		(11.6)	(3.7)	(11.7)	**(9.0)**	(11.5)	(11.5)	**(11.5)**	(11.0)

5. REVENUE EXPENDITURE

Table 5.1 shows the composition of total revenue expenditure. The share of salaries has fallen from 39 percent of total revenue expenditure in 1999-2000 to 31 per cent in 2004-2005. Salaries and pensions together have fallen from 55 per cent of the total in 1999-2000 to 46 per cent in 2004-2005.

It is the annual interest bill that has stubbornly risen by Rs.1660 crore between 1999-2000 and 2004-2005. Whether or not the debt concessions offered by the TFC will make a dent in the massive annual interest bill, running at Rs.4000 crore, is a function of the composition of the debt stock. This will be addressed in Section 7.

When interest is added to salaries and pensions the three together pre-empt two-thirds of revenue expenditure, although this is still lower than the 71.5 per cent share in 1999-2000, notwithstanding the rise in interest.

The order already issued in March 2006 revising salary scales in accordance with the recommendations of the Sixth Pay Revision Commission of Kerala will reverse the decline in the share of salaries and pensions. Salaries and pensions have been revised at five-yearly intervals in Kerala (on the basis of recommendatory bodies, not all of which are called Commissions), so that this development is perhaps in line with the historical periodicity of the pay fixation cycle. What is absolutely vital is that there should be a restructuring and rightsizing of the bureaucracy accompanying the pay revision. The burden of the pay revision, which will be borne in the financial year 2006-2007, is estimated to amount with arrears to Rs. 3000 crore. This by itself could endanger the ability of the state to honour the fiscal correction conditionalities as notified by the Union Finance Ministry, in its interpretation of the recommendations of the Twelfth Finance Commission.

The pension bill in Kerala is very high because the retirement age remains at 55, and life expectancy in the state, at 73.5 years, is ten years higher than the median for all other states. The number of pensioners, by the 2006 Report of the Sixth Pay Revision Commission of Kerala, stood at 284,200 by the end of 2002-2003 (para 8.4.02). The numbers added in the next two years raise this to 328,110 by the end of 2004-2005, before adjustment for attrition through mortality. The stock of pensioners is thus as high as seventy per cent of the size of serving staff, which stood at 459,289 by the end of 2005-2006 (as reported in Appendix-I to the Budget papers for 2006-2007). Given this structural disadvantage, it is absolutely vital that it should join the sixteen other states that have moved to a defined contribution system, and move away from the defined benefit system presently in place. There was an announcement that this would be done with effect from 1 April 2005, but it has not been implemented.

TABLE 5.1

REVENUE EXPENDITURE

Revenue Expenditure	*PRE-FRA period*					*FRA period*			
	Actual				*Average*	*Actual*		**Average**	**R.E.**
	1999-00	*2000-01*	*2001-02*	*2002-03*	*2000-03*	*2003-04*	*2004-05*	**2003-05**	**2005-06**
Composition									
Total Expenditure in Rs. Cr.	11563	11878	11662	14756		15496	17169		21090
(%)	(100.0)	(100.0)	(100.0)	(100.0)		(100.0)	(100.0)		(100.0)
Salaries (%)	(38.9)	(37.8)	(36.0)	(31.7)		(32.7)	(31.1)		(30.1)
Pensions (%)	(15.6)	(16.2)	(15.8)	(15.5)		(15.5)	(15.1)		(15.6)
Salaries+ Pensions (%)	(54.6)	(54.1)	(51.8)	(47.2)		(48.2)	(46.3)		(45.7)
Interest (%)	(16.9)	(19.0)	(21.4)	(20.0)		(21.5)	(21.0)		(18.5)
Salaries+Pensions+Interest (%)	(71.5)	(73.1)	(73.1)	(67.2)		(69.7)	(67.3)		(64.2)
Annual Increase (%)									
Total expenditure		2.7	-1.8	26.5	**8.5**	5.0	10.8	**7.9**	22.8
Salaries		-0.2	-6.5	11.4	**1.3**	8.3	5.5	**6.9**	18.8
Pensions		6.7	-4.8	24.2	**8.1**	5.5	8.0	**6.7**	26.2
Salaries+Pensions		1.8	-6.0	15.3	**3.3**	7.4	6.3	**6.8**	21.2
Interest		15.7	10.3	18.4	**14.7**	12.9	8.6	**10.7**	8.3
Salaries+Pensions+Interest		5.0	-1.7	16.2	**6.2**	9.0	7.0	**8.0**	17.2
GSDP		11.6	3.7	11.7	**9.0**	11.5	11.5	**11.5**	11.0

6. SECTORAL ISSUES: EDUCATION AND HEALTH

Kerala has been held out universally as one of the shining examples for achieving high level of human and social development at comparatively low levels of economic development. The state is ranked number one in terms of human development index prepared by the Planning Commission and Social Development index prepared by the Council for Social Development, New Delhi. The achievements of the state in education and health are far above those of other states. The level of literacy in the state is above 90 per cent as against the national average of 65. The female literacy is as high as 87 per cent in comparison to the national average of 54. Life expectancy in the state is close to 75 years as compared to 64 for the country as a whole. The latest estimates of infant mortality indicate that it has come down to single digit level as compared to the national average of 60.

The state had achieved commanding heights in educational and health fields even when the per-capita income of the state was well below the national average. This pattern of development characterised by high quality of life without much economic growth, was raised to the status of a ‘model’ in the international development literature. But doubts were also expressed from various quarters about the substantiality of Kerala model of development. The feasibility of continued state financing of social services was doubted by fiscal experts. With the prospects of continued gulf remittances being uncertain, the private sources of financing also remained unreliable. There had been thus a big question mark over the future of human development in the state in the face of a fragile economic base in terms of an insignificant industrial sector and shrinking agriculture.

During the 1990s, however, per-capita real income growth in Kerala for the first time was above the national average, as a result of the accelerated growth of the services sector during the decade. By the early years of the twenty-first century, the per-capita income of the state has come up well above the national average and is now comparable to that of Gujarat and Tamil Nadu, two of the industrially advanced states in the country. For the first time human development and economic growth seem to have started reinforcing one another positively. It is expected that this trend will continue given the contribution of the services in the overall growth of transition economies.

Education

According to the Sixth All India Educational Survey conducted by the NCERT in 1993-1994, in Kerala 90 per cent of the population had a lower primary school, 67.5 per cent an upper-primary school and 62 per cent a secondary school within 1 km. By the 1980s enrolment at the primary level was near universal, virtually without any gender gap. Further, dropout rates are lower for girls as compared to boys. Another welcome aspect of gender empowerment is the fact that two-third of the school teachers are women.

Public spending on education in Kerala has been one of the highest among the states both as a share of state budget and NSDP. School education accounts for more than 80 per cent of education expenditure in Kerala as compared to just around 65 per cent for the country. On account of the increasing fiscal stress the share of public expenditure on education has come down from above 6 per cent of NSDP in the 1980s to below 5 per cent in the 1990s.

The relatively rapid decline in the birth rate in the state has important implications for resource allocation to the education sector. Total school enrolment reached a peak in 1991-1992 and it has been steadily falling since then. As a result the pupil-teacher ratio has come down from 31 in 1991-1992 to 28 in 2002-2003. There is some scope for reducing the salary component of education expenditure by allowing an increase in the pupil-teacher ratio.

The distribution of students between government schools, government-aided schools, and unaided schools has undergone a significant change (there is also a class of unrecognized schools). While the enrolment in government schools fell by a quarter in the 1990s, it increased by about 80 per cent in unaided schools. The popularity of private unaided schools is an indicator of the perceived quality problem in government and government aided schools.

The efficiency of public expenditure on education in Kerala is a serious issue. Teacher costs accounts for 85 per cent of spending on education in the state. A source of drain on the public exchequer is the maintenance of ‘protected teachers’ in the wake of falling admissions. About 3800 such surplus teachers were identified in government schools in 2003. Their redeployment to private aided schools is resisted by the teachers as well as the private management.

In the wake of de-linking of pre-degree course from colleges and the introduction of higher secondary course in schools, another fiscal efficiency problem arose. A massive number of college teachers became surplus but only a few moved to the new higher secondary schools. They continue to remain as ‘protected lecturers’ drawing salary from public exchequer. In the meanwhile 20,000 posts of higher secondary school teachers in government and aided schools have been filled by fresh recruitments.

Health

The achievements of Kerala in health sector are even more spectacular than in education. Health indicators like life expectancy and infant mortality in the state are comparable to those in developed countries. These are the outcomes of investment in health infrastructure in all sectors, public, private and co-operative, along with people’s awareness of their health needs. Kerala’s health care network in the public sector under the three systems of Allopathy, Ayurveda and Homoeopathy had a total of 7831 institutions in 2001-2002. This allows accessibility and choice of the preferred system of medicine for vast majority of the people even in the public sector.

As in the case of education, private provision far exceeds public provision in health care. It is estimated that in the private sector there are 12,328 medical institutions in the state with 70,506 hospital beds. This included 4,288 allopathic institutions, 4,922 ayurvedic institutions and 3,118 homoeopathic institutions. In terms of hospital beds also the private sector is ahead of public sector. It is obvious that a sizeable share of demand for health care is met by these private institutions.

While the public sector offers accessibility and choice, it is not highly rated in terms of perceived quality. As a result the private sector has established parallel institutions to take advantage of the potential demand for quality health care. The viability of these private institutions is ensured by the large remittances flowing into the state from migrants. The rural-urban continuum facilitates the deployment of health functionaries even in villages. Clustered large villages with high population density with good road and communication network enabled establishment of viable private hospitals even in rural areas.

There is a qualitative difference between public and private sector provision of health care and education. While the vast majority of private educational institutions are aided by the government, there is no direct fiscal burden on account of the operations of private health care institutions. It also implies that public and private education complement one another but public and private health care compete with each other. In the absence of any significant health insurance the choice of health care is decided by the paying capacity.

Improvement in the quality of public health care has been an important concern of the state government. Indeed, Kerala had taken some initiatives in this direction early. Hospital Development Committees were set up in the state in the 1980s for all the major public hospitals. The Committees represented the civil society including all the political parties. These Committees are expected to find local solutions to felt needs. They are permitted to collect user charges for some services and spend the money on the development of the Hospitals as decided by them. Hospital charges are also collected through the Treasury and on both these parameters of cost recovery the experience of the state has been one of the best in the country. It is not, however, clear to what extent these measures have affected the health care seeking behaviour of the poor in the state.

A combination of incentives embedded in the pattern of funding available under the MPLADS and other schemes has led to capital investment in a large number of spatially dispersed health facilities, with low utilization rates. There is insufficient financial provision built in for the free drugs supplied by many of these institutions, and for salary support. As a consequence, drug companies frequently face non-payment, in much the same way in which construction contractors carry arrears from the Public Works Department. The salary support issue has already been dealt with in section 3.

Issues

The 73rd and 74th amendments to the Constitution ordained that several subjects included in the state list will be transferred to the third tier of government i.e., Panchayats and Municipalities. These included education and health also. Only very few states have made genuine efforts to democratically decentralise education and health, Kerala being in the forefront among them. Initially there was resistance from the employees. However, this was overcome by allowing dual control of the staff by the state departmental machinery and the elected bodies at the district, block, panchayat and municipal levels. An assessment of the functioning of the educational and health care institutions under the new dispensation from the points of view of financial management, efficiency and quality of services may be useful.

Kerala’s demographic transition has both positive and negative impacts on state finances. Since the expansionary phase of educational infrastructure is already over, additional budgetary support will be needed only for maintenance and upgradation. On the other hand, an aging population with increasing morbidity will necessarily require more health infrastructure. The private sector certainly will continue to expand to occupy this space. Equity considerations, however, will demand the state to play its role and share the burden of increased health care expenditure.

Kerala, with its head start in education and health care could have emerged as a hub for these services ahead of other states. Instead, the other southern states and Maharashtra took a lead in this field. Quite a large number of students from Kerala have been going to these states for professional education and spending a substantial sum on that account. Of late the State Government has changed its policies in this regard, and a large number of professional educational institutions have been coming up in the private sector. In the health sector also, private players are active and the state has earned a reputation as the destination for health-tourists. In view of the labour absorbing nature of these activities the state can benefit immensely from a continued pro-active policy in this regard.

With the decline in health afflictions common to other parts of India, the health problems of the state have become similar to those in the developed world. Geriatric ailments will assume increasing prominence in a state where by 2020, 30 percent of the population will be over sixty years of age. The need for two-laned highways with road dividers, so as to bring down the very high road accident rate in the state has already been referred to in section 2. In the interim, there is a need for the health system to cope with the high incidence of accident and trauma cases. Finally, Kerala state has the unfortunate distinction of suicide rates at 3.5 times the national average for males, and roughly twice the national rate for females. Clearly the health system of the state needs to be better geared to supply preventive and curative services for stress-induced and other psychiatric disorders.

Lastly, the principal concern of the State Government should be to ensure that quality of public provision of education and health care are maintained to effectively compete with the private sector in these fields. For this, two essential requirements needed are: (i) complementary inputs for teachers and medical personnel to function effectively and (ii) an effective mechanism for ensuring accountability. Hopefully, the latter will be taken care of by the democratic decentralisation process.

7. DEBT

The closing debt stock at the end of 2004-05 was 41.7 percent of GSDP that year (table 7.1). Most of the increase from the level of 38.4 percent of GSDP at the start of the FRA period took place in 2003-04, when the fiscal deficit actually rose as a percent of GSDP relative to the previous year (section 2).

An important contributory factor to the slowdown in the debt/GSDP ratio has been the higher rate of GSDP growth of 11.5 percent since 2003-04, higher than the rate of interest on debt, at around 9.4 percent. This has given room for accommodation of some though not all of the primary fiscal deficit run during these two years. In the pre-FRA period, the interest rate was at an average of 10.3, and GSDP growth was at 9 percent.

Notwithstanding the slowdown in the rise of the debt/GSDP ratio, the closing level after two years of a fiscal correction programme at over the 40 percent mark, coupled with an average rate of interest at 9.4 percent, implies an interest bill at around 3.8 percent of GSDP (corresponding to the difference between the fiscal deficit and the primary fiscal deficit in table 2.1). With own revenue of the state at 10 percent of GSDP, interest payments on past fiscal imbalances pre-empt nearly 40 percent of own revenue collections. It is for this reason alone that the debt/GSDP ratio requires to be stabilised, and eventually reversed, quite independently of the timetable of the FRA. The debt/GSDP ratios for the other southern states are much lower, at 32 percent (Andhra Pradesh), and 28 percent (Karnataka and Tamil Nadu).

The composition of debt has altered between 1999-2000 and 2004-05. Loans from the Centre have declined from 29 to 13 percent of total debt. The decline in importance of loans from the Centre is in part on account of the accounting change with the creation of the NSSF in 1999-2000. The average annual rate of increase in debt from the NSSF rose from 59 percent over 2000-03 to 75 percent over 2003-05. The interest payout on this portion has benefited from the decline in rates on small savings since 2001, so that the NSSF was not, in 2004-05, the highest-cost source of borrowing for the state. Loans from the Centre, as well as internal debt other than from the NSSF, carried average rates of interest in 2004-05 of 11.93 percent and 10.65 percent respectively, considerably above that on debt from the NSSF, which stood at 9.95 percent. Nevertheless, the compulsion to tap this source is a constraint on the freedom of the state to configure its own debt portfolio.

The advantage to Kerala of the Twelfth Finance Commission (TFC) concession on interest rates on debt owed to the Centre by three percentage points to 7.5 percent (assuming a pre-concession rate of 10.5 percent), conditional on enactment of an FRA with reduction of the RD to zero by 2008-09, amounts to only 4 percent of the total interest bill, because of the relative unimportance of Central debt in the total debt portfolio. But since the state had an FRA predating the TFC provision, it loses nothing by amending the Act to conform to the new requirements, especially since the new targets are less demanding than those in the original Act.

Contingent liabilities of the State Government are capped at an absolute level of Rs.14,000 crore, under the Kerala Ceiling on Government Guarantees Act of 2003. This cap is not risk-weighted. At the conclusion of 2003-04, the total guaranteed amount outstanding, at Rs.13,996 crore, was just under the legislated cap. It has since been brought down to Rs.12,316 crore, at the conclusion of the financial year 2004-05, inclusive of interest outstanding along with the principal amount guaranteed. The reduction is a commendable feature of fiscal management by the State Government. It would be wise not to add further to the principal guaranteed so as to leave room for accommodation of interest outstanding within the legislated cap.

TABLE 7.1

COMPOSITION OF DEBT

	Pre-FRA period					*FRA period*				
	Actual				*Average*	*Actual*		*Avg.*	*R.E.*	*B.E.*
	1999-2000	*2000-01*	*2001-02*	*2002-03*	*2000-03*	*2003-04*	*2004-05*	*2003-05*	*2005-06*	*2006-07*
Composition										
Total Debt in Rs. cr.	20176	23919	26951	31060		37452	41878		47791	54620
(%)	(100.0)	(100.0)	(100.0)	(100.0)		(100.0)	(100.0)			
Internal debt (%)	28.4	31.9	34.7	37.8		46.5	51.8			
of which NSSF (%)	2.8	4.2	5.5	7.4		12.2	16.8			
Loans from Centre (%)	(29.3)	(25.5)	(23.6)	(21.0)		(15.0)	(12.9)		(12.0)	(13.4)
PF, fixed deposits (%)	42.3	42.6	41.8	41.1		38.5	35.3			
Annual Increase (%)										
Total debt		18.6	12.7	15.2	**15.5**	20.6	11.8	**16.1**	14.1	14.3
NSSF		77.2	45.8	56.3	**59.2**	98.5	54.0	**74.8**		
GSDP		11.6	3.7	11.7	**9.0**	11.5	11.5	**11.5**		
Yearly Values (%)										
Debt/GSDP (%)	**32.3**	**34.3**	**37.3**	**38.4**		**41.5**	**41.7**		**42.8**	**43.3**
Interest rate (%)	10.9	10.2	9.8	10.2	**10.3**	9.7	9.1	**9.4**		

8. CONCLUDING ASSESSMENTS AND RECOMMENDATIONS

8.1 ***Assessment of Fiscal Deficit Correction:*** Starting from a fiscal deficit (FD) of 5.53 percent of GSDP in 2002-03, the year just before the Fiscal Responsibility Act (FRA), a target FD of 3 percent of GSDP by 2008-09 calls for a reduction in the FD by 0.42 percentage points per year. This assumes that the Kerala Act will be amended to be in conformity with the stipulations of the Twelfth Finance Commission (TFC), which are less stringent than the original FRA target for the FD, of 2 percent of GSDP by 2006-07. The FD actually rose in 2003-04 by 0.61 percent of GSDP, but was reduced in 2004-05 by 1.71 percent, thus more than compensating for the rise in 2003-04. Aggregating across the first two years of the FRA, therefore, the FD correction remains in conformity with the (amended) correction requirement.

8.2 ***Trajectory of Debt/GSDP:*** Correspondingly, the ratio of debt to GSDP has risen more slowly after the FRA than in the three years preceding. An important contributory factor has been the higher rate of nominal GSDP growth of 11.4 percent since 2003-04, higher than the nominal rate of interest on debt, at around 9.5 percent. This has given room for accommodation of some, though not all, of the primary fiscal deficit during these two years. Notwithstanding the slower growth of debt/GSDP after enactment of the FRA, it stood at 41.7 percent at the close of 2004-05. The debt/GSDP ratios for the other southern states stand at approximately 32 percent (Andhra Pradesh), and 28 percent (Karnataka and Tamil Nadu).

8.3 ***Interest Outflow:*** A debt/GSDP ratio over the 40 percent mark, coupled with an average rate of interest at 9.5 percent, implies an annual interest bill approaching 4 percent of GSDP, corresponding to the difference between the fiscal deficit and the primary fiscal deficit shown in table 2.1. This huge drain on the public exchequer is what prescribes the imperative need to stabilize and eventually reduce the public debt as a percentage of GSDP, quite independently of the FRA. The revenues of the state need to be directed towards the welfare of the citizens of the state, rather than towards servicing of debt accumulated in the past.

8.4 ***Growth and Capital Outlay:*** An essential, though clearly not sufficient requirement is that the higher GSDP growth of 2003-05 has to be sustained into the future. For this to be possible, it is necessary to underscore the need to protect productive capital outlays in the budget, and restrain unproductive expenditures, such as for example on pensions. Physical infrastructure in Kerala state is seriously underprovided in some sectors such as drainage and waste water disposal. This is leading to sewage contamination of well water used for drinking purposes, and therefore to the spread of avoidable diseases. The Kerala Rural Water Supply and Sanitation Project (Jalanidhi), an integrated project for improvement of the quality of rural water supply, implemented through local beneficiary groups is an excellent first step in the right direction.

8.5 ***Assessment of Revenue Deficit Correction:*** If the Kerala FRA is amended to be in conformity with the TFC targets, the target year for a zero revenue deficit (RD) is moved back to 2008-09 in place of 2006-07, and the correction period to reach that target therefore gets stretched over six instead of four years. Starting from the pre-FRA RD of 5.09 percent of GSDP in 2002-03, the amended required annual decline is thereby lowered to 0.85 percent of GSDP. The actual decline in the RD of 1.01 percentage points in 2003-04, and 0.43 percentage points in 2004-05, falls short of the combined requirement over two years, by 0.26 percent of GSDP.

8.6 ***Pattern of Fiscal Correction:*** Thus the pattern in the first two years of the FRA has been sharp correction in the RD in 2003-04, the first year, accompanied by a rise in the FD, followed in 2004-05 by a less sharp cut in the RD, with a very sharp cut in the FD. Underlying this observed pattern is the volatile year-to-year behaviour of the net lending component of capital expenditure (capital outlays have been relatively stable). The rise in the FD in 2003-04 was driven by a single large loan of Rs. 1149 crore to the Kerala State Electricity Board (KSEB), towards purchase of Power Bonds of the National Thermal Power Corporation (NTPC), in lieu of dues owed by KSEB to NTPC. Although these episodic loans are not in general desirable, the purchase of Power Bonds was a necessary settlement of dues to the NTPC.

8.7 ***Dues of Public Sector Undertakings:*** There is an immediate need for a one-time sorting out of outstanding dues of public sector undertakings of the state, along the lines of what was done in the NTPC case. The Kerala Water Authority (KWA) is given non-plan grants to cover its operating losses, on account of non-payment by panchayats of water bills. Likewise, KWA is in default of payments owed to the KSEB. With effect from 2005-06, fifty percent of dues to the KWA will be payable directly to the KSEB. These are all steps in the right direction. There has to be an additional withholding of annual grants to panchayats in respect of payments due to KWA. Intra-governmental dues need to be immediately sorted out along these lines.

8.8 ***The Adjusted Revenue Deficit:*** The ultimate purpose of having separate targets for revenue and fiscal deficits in FRA legislation is to have separate controls on revenue expenditure, and thereby to provide a larger permissible margin for growth-promoting capital expenditure. This purpose is defeated if capital expenditures are classified under the revenue head. Grants to local bodies, even if intended for capital outlays, are required to be booked in the revenue account because of the impossibility in an accounting sense of making a capital grant. Similarly, PWD expenditure on the revenue account on maintenance of roads and infrastructure is indistinguishable from new capital outlays in character. Transfer to capital outlays of half of these expenditures, as a first approximation, yields an adjusted revenue deficit lower than the reported RD by approximately 1.2 percentage points of GSDP. Starting from an RD, so adjusted, of 3.88 percent of GSDP in 2002-03, the yearly required reduction in the adjusted RD is 0.65 percent of GSDP. The achieved reduction over two years is 1.42 percent, higher than the 1.30 percent required. Thus, the adjusted revenue deficit alters the conclusions drawn earlier about the failure to measure up fully to the revenue account correction required. There is, therefore, a case for further fine-tuning the approximate correction made here, so that an accurate estimate may be possible of the true revenue deficit. There is a strong case for amending the Kerala FRA so as to target the adjusted RD along these lines, and for a case to be made to the Union Finance Ministry to allow such an amendment for fulfillment of the TFC conditionalities.

8.9 ***Adjusted Capital Outlay:*** The adjustment in paragraph 8.8 raises capital outlay, from the 0.7 percent of GSDP observed in the unadjusted figures, to an adjusted capital outlay at nearly 2 percent of GSDP.

8.10 ***Reporting of Capital Expenditures:*** There needs to be a consistent distinction in the official figures between capital outlay, capital expenditure (outlay plus net loans), and capital disbursement (outlay plus gross loans).

8.11 ***Additional Public Funding of Capital Outlay:*** A further augmented capital outlay, including capital outlays funded under the MPLAD and SDFMLA schemes, would yield a useful handle on the aggregate publicly funded capital outlay in the state, other than outlays funded directly by the Central Government.

8.12 ***Unpaid dues:*** The fiscal deficit remains unaltered by the adjustment described in paragraph 8.8. However, there are unpaid dues of departments, such as for example dues owed to contractors by the Public Works, Irrigation and Harbour Engineering Departments. The difference between the opening and closing stocks of dues must be added on to the reported fiscal deficit to obtain a truer picture of the change in liabilities of the government in the course of the fiscal year.

8.13 ***Matching Fund Lapsing Cycles to Capital Projects:*** Lapsing of funds is critical for expenditure incentives to be built into the system. However, the lapsing cycle for capital outlays needs to be matched to the time-profile of projects. The stringent procedures governing capital expenditures make it difficult for expenditures to conform to a single-year lapsability structure. In Kerala where the density of roads is high, the need is for two-laning of pre-existing roads, and building of road dividers, so that the very high accident rate can be brought down. This calls for extended initial time for land acquisition. These delays need to be responsibly estimated and built into the lapsability structure up-front.

8.14 ***Evaluation of Capital Investment Projects:*** The institutional mechanism for estimating the internal rate of return on capital investment projects needs to be strengthened, so that projects can be ranked and prioritized. The need for this is especially acute among local bodies. Funding from MPLADS and SDFMLA is allocated at the discretion of the MP or MLA in question. Large episodic receipts of this kind go into creation of hospitals and other infrastructure unmatched to the disease burden or other local needs, and with low utilization rates. A commendable recent decision by the State Government not to lend salary support for operation of infrastructure created by local bodies through funding from either these schemes or general grants from the state, will put an end to the creation of unviable infrastructure.

8.15 ***Revenue Receipts:*** Total revenue receipts (TRR) grew at 12.7 percent on average over the first two years 2003-05 of the FRA period, higher than the annual average of 10.2 percent achieved over the three years immediately preceding, 2000-03. However, this was driven by the higher rate of growth of transfers from the Centre, aggregating across tax shares and grants, at 18.4 percent over 2003-05, as against a mere 6.2 percent annual rate of increase over 2000-03. The high rate of growth of Central transfers will continue into 2005-06, the first year in the period mandated by the Twelfth Finance Commission (TFC), because of the more generous provision for states in general (the reduced share of Kerala in Central taxes was compensated by a deficit grant). That, however, will not translate into a corresponding increase in the year-to-year growth in Central transfers during the TFC period beyond 2005-06. The state should not, in any case, rely on Central transfers to provide the revenue support for the achievements of the targets of the FRA.

8.16 ***Own Tax Revenue:*** Fiscal restructuring necessarily implies better effort on all fiscal handles under the control of the state. Own tax revenue registered a **lower** annual rate of increase, at 10.8 percent in the first two years of the FRA period, than the annual increase of 12.0 percent over 2000-03. The buoyancy of own tax revenue (obtained through simple division of the compound annual growth rate of revenue by that for nominal GSDP, rather than through econometric estimation) came down to 0.9, as against 1.3 in the period 2000-03. Thus, the state has not been able to translate the higher rate of GSDP growth into a higher rate of own revenue growth. This is a major structural failing. It is possible that the higher revenue flow from the Centre may have caused the drop in own tax effort, contrary to what is termed the flypaper effect in the literature. The only good feature of own tax revenue performance in the FRA period is that the annual growth has been more uniform than in the period 2000-03, when it was more volatile.

8.17 ***Own Non-tax Revenue:*** Non-tax revenue did slightly better in annual average growth terms in 2003-05 than in 2000-03, but the buoyancy was lower nevertheless. In this case, the year-to-year growth has remained as volatile as in earlier years.

8.18 ***Own Revenue Effort:*** The own revenue of the state currently adds up to around Rs. 11,000 crore, amounting to 10 percent of GSDP. Of this, the own tax component has not risen above a steady 9 percent of GSDP in the three years going up to 2004-05. Although own taxes are at about the same percentage of GSDP in the other southern states, it has to be remembered that Kerala is a remittance-receiving state, from a large diaspora. These remittances do not get recorded in the GSDP figures at state level, which are at factor cost. Since taxes are levied on expenditure, which is funded out of household disposable income inclusive of external remittances, the Kerala own tax revenue to GSDP ratio should be higher than for other states not receiving remittance income.

8.19 ***Value Added Tax:*** The state switched over to a VAT along with the majority of other states on 1 April 2005. However, the VAT does not apply to four items which together contribute roughly half of the total sales tax revenue of the state (petroleum products, sales tax on liquor, aviation turbine fuel, and entry tax). The VAT rates are lower than the pre-

VAT rates, but the Centre has underwritten a guaranteed increase in tax revenue at 17.94 percent with respect to the previous year in respect of items subject to the VAT, with full compensation for 2005-06.

8.20 ***Salaries:*** The share of salaries has fallen from 39 per cent of total revenue expenditure in 1999-2000 to 31 per cent in 2004-2005. Salaries and pensions together have fallen from 55 percent of the total in 2001-2002 to 46 percent in 2004-2005. This decline will be reversed with the implementation in March 2006 of the recommendations of the Sixth Pay Revision Commission. Salaries and pensions have been revised at five-yearly intervals in Kerala (on the basis of recommendatory bodies, not all of which are called Commissions). What is absolutely vital is that there should be a restructuring and rightsizing of the bureaucracy accompanying the pay revision. Also, it is vital that project-specific staff should not be appointed, since that creates an embedded incentive for the project to remain incomplete, as for example on the Kallada and other long pending major irrigation projects.

8.21 ***Pensions:*** The number of pensioners, by the 2006 Report of the Sixth Pay Revision Commission of Kerala, stood at 284,200 by the end of 2002-2003 (para 8.4.02). The numbers added in the next two years raise this to 328,110 by the end of 2004-2005, before adjustment for attrition through mortality. The stock of pensioners is thus as high as seventy per cent of the size of serving staff, which stood at 459,289 by the end of 2005-06 (as reported in Appendix-I to the Budget papers for 2006-07). The high pensioners base is because the retirement age remains at 55, whereas life expectancy in the state, at 73.5 years, is ten years higher than the median for all other states. Given this structural disadvantage, it is absolutely vital that Kerala should join the sixteen other states that have moved away from a defined benefit system to a defined contribution system. There was an announcement that this would be done with effect from 1 April 2005, but it has not been implemented.

8.22 ***Guaranteed Debt:*** The absolute cap of Rs.14,000 crore, under the Kerala Ceiling on Government Guarantees Act of 2003 has not been violated. Total guaranteed debt outstanding, at Rs.13,996 crore at the conclusion of the financial year 2003-2004, was reduced by the end of 2004-2005 to Rs.12,316 crore, inclusive of interest outstanding along with the principal amount guaranteed. The reduction is a commendable feature of fiscal management by the State Government. It would be wise not to add to the principal guaranteed so as to leave room for accommodation of interest outstanding within the legislated cap.

8.23 ***Budget Estimates and Actuals:*** The RD as budgeted in 2004-2005 was higher than actuals for the year preceding by 2 per cent of GSDP. Although the actuals for 2004-2005 show the RD well below what was budgeted, the issue of fiscal marksmanship is an important one. Large disparities between budget estimates and actuals reduce the value of the annual budget as an accurate predictor of revenue and expenditure for the forthcoming year.

8.24 ***Tracking of Schemes:*** As is the present practice by the Government of India, a document tracking the progress of on-going schemes, and action taken on announcements made in the previous budget, would be a useful addition to the budget papers presented before the Legislature every year.

8.25 ***Supplementary Demands for Grants:*** When the Government issues supplementary demands for grants in the course of the fiscal year, no corresponding revenue source is presently identified. Fiscal prudence demands that additional expenditures should be matched by additional revenues.

8.26 ***Achievements and Challenges in Health:*** Kerala's triumphant achievements in health indicators like life expectancy and infant mortality, comparable to those in developed countries, are the outcomes of investment in health infrastructure in all sectors, public, private and co-operative. Cost recovery from users of public hospitals has been among the best in the country, through a system of Hospital Development Committees. The state health system now needs to be reconfigured to the particular requirements of Kerala State. This is the challenge. The very high road accident rate has already been referred to in section 2, calling for two-laned highways with road dividers. In the interim, there is a need for the health system to enhance its capacity to deal with accident and trauma cases. Kerala State has the unfortunate distinction of suicide rates at 3.5 times the national average for males, and roughly twice the national rate for females. Clearly there is a pressing need for preventive and curative services addressed towards stress-induced and other psychiatric disorders. Finally, geriatric ailments will assume increasing prominence in a state where by 2020, thirty percent of the population will be over sixty years of age.

8.27 ***Achievements and Challenges in Education:*** Literacy in Kerala is above 90 per cent, as against the national average of 65. Female literacy is at 87 per cent, in comparison to the national average of 54. The relatively rapid decline in the birth rate in the state however has led to a steady decline in school enrolment after 1991-1992. While the enrolment in government schools fell by a quarter over the 1990s, it increased by about 80 per cent in unaided schools, as a result of a perceived quality problem in Government and Government Aided Schools. The maintenance of 'protected teachers' in the face of this decline has been a needless drain on the public exchequer. The redeployment of 3800 teachers, identified as surplus in government schools in 2003, to private aided schools has been resisted by the teachers as well as the private management of those schools. De-linking of the pre-degree course from colleges and introduction of the higher secondary course in schools, rendered a massive number of college teachers surplus, but only a few have been moved to the new higher secondary schools. They continue to remain as salary-drawing 'protected lecturers', while 20,000 posts of higher secondary school teachers in government and aided schools have been filled by fresh recruitments. Fiscal correction in the state can only be achieved when expenditures on functionaries correspond to a particular function rendered towards the people of the state.

APPENDIX I

DELIVERABLES OF THE PUBLIC EXPENDITURE REVIEW COMMITTEE

1. The review report referred to in section 7 shall be submitted by the Committee to the Government during the month of November every year, following the constitution of the Committee.

2. The review report shall give full account of each item where the deviation from the fiscal target occurred during the previous year.

3. The review report shall also contain the following details namely:

   a. revenue receipts with break-up of

      i. State's own tax revenues

      ii. Non tax revenues, and

      iii. Resources from the Centre;

   b. revenue expenditure with break up of

      i. interest
      ii. salaries
      iii. pensions
      iv. subsidies (power, food, transport, housing, industry and others)
      v. operation and maintenance
      vi. devolution to Local Self Governments
      vii. administrative expenditure and
      viii. other revenue expenditure

   c. revenue deficit;

   d. primary deficit;

   e. capital receipt;

   f. expenditure on capital;

   g. fiscal deficit;

   h. total debt stock;

   i. debt services;

   j. off-budget borrowings, and guarantees.