



Government of Kerala

Report of the
**KERALA PUBLIC EXPENDITURE
REVIEW COMMITTEE**

FOURTH COMMITTEE

SECOND REPORT (2015-2016)

FEBRUARY 2018

**REPORT OF
THE KERALA PUBLIC EXPENDITURE
REVIEW COMMITTEE**

FOURTH COMMITTEE

{Constituted as per Gazette Notification No. G.O (P) No. 37/2017/Fin dated 17.03.2017
(S.R.O No.132/2017) as prescribed under Section 6 of the Kerala Fiscal Responsibility Act,
2003(29 of 2003)}

SECOND REPORT (2015-16)

February 2018

Preface


The first report of the 4th KPERC constituted as per gazette notification G.O (P) No 37/17/Fin dated 17/3/17 was submitted in August 2017. This is the second report of the Committee for the Financial Year 2015-16. As mandated in the Act, various aspects of the State Finance pertaining to 2015-16 accounts have been analysed in this report.

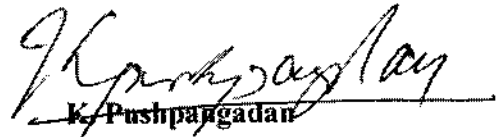
The Committee is grateful to Shri. Manoj Joshi, Principal Secretary, Finance Department, Government of Kerala for the help received from the Finance Department in preparing this report. The officers of the Finance Department have supported us in many ways which helped us complete two reports in quick succession. The Committee expresses its gratitude to the Director and staff of Gulati Institute of Finance and Taxation for hosting the meetings of the Committee and in facilitating work of the Committee.

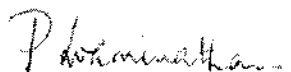
The Committee acknowledges the effort put in by Shri M.Chandra Dhas, Secretary of the Committee in preparing a preliminary draft of the report. Shri. Ajith.S, Accounts officer, Finance Department, provided invaluable research assistance, Shri.Abhilash.S, Section Officer, Finance Department provided timely data on certain key areas while Shri KarthikaRaj.P and Ajayakumar T. I provided necessary secretarial assistance. The Committee places on record its appreciation of the services provided by all these officers.



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Glossary

GSDP	Gross State Domestic Product
GDP	Gross Domestic Product
MTFP	Medium Term Fiscal Policy
SOTR	State's Own Tax Revenue
SONTR	State's Own Non Tax Revenue
CSS	Centrally Sponsored Scheme
LSGs	Local Self Governments
FC	Finance Commission
NPRD	Non Plan Revenue Deficit
CE	Capital Expenditure
RD	Revenue Deficit
FD	Fiscal Deficit
SNTR	State's Non Tax Revenue
KFRBMA	Kerala Fiscal Responsibility and Budget Management Act
FRBM	Fiscal Responsibility and Budget Management
FFC	Fourteenth Finance Commission
BE	Budget Estimate
UDAY	Ujwal DISCOM Assurance Yojana
IMFL	Indian Made Foreign Liquor
KSBC	Kerala State Beverages Corporation
RE	Revised Estimate
GST	Goods and Services Tax
VAT	Value Added Tax
SGST	State Goods and Services Tax
C&AG	Comptroller and Auditor General

TSB	Treasury Savings Bank
SDG	Supplementary Demands for Grants
GO	Government Order
ICDS	Integrated Child Development Scheme
NSSF	National Small Savings Fund
EAP	Externally Aided Project
CSF	Consolidated Sinking Fund
GRF	Guarantee Redemption Fund
NBER	National Bureau of Economic Research
PERI	Political Economy Research Institute
AIC	Average Interest Cost.

Chapter 1

An Overview of the State Economy and Public Finances

1.1 State Economy- A Brief Profile

1.1 The Gross State Domestic Product (GSDP) at current prices of Kerala grew at 8.59 per cent in 2015-16 compared to 10.22 per cent in 2014-15. At the all India level also, the growth rate of Gross Domestic Product (GDP) at current prices declined from 10.79 per cent to 9.94 per cent.¹The relatively poor performance of the Kerala economy is on account of the pronounced growth deceleration in the secondary and tertiary sectors and the negative growth of the primary sector output. Table.1.1 gives a comparison of sector-wise growth rates of Kerala's GSDP and all India GDP at current prices for the period 2012-13 to 2015-16.

Table 1.1: GSDP and GDP Growth Rates, Kerala and All India: 2012-13 to 2015-16

(% per annum)

Year	Primary	Secondary	Tertiary	GSVA(GVA)	GSDP (GDP)
2012-13	3.80 (11.23)	10.22 (11.1)	17.42 (15.98)	13.38 (13.5)	13.26 (13.82)
2013-14	11.29 (13.32)	9.27 (9.8)	14.30 (13.94)	12.54 (12.6)	12.79 (12.92)
2014-15	14.17 (7.24)	6.53 (8.8)	10.46 (13.38)	9.95 (10.8)	10.22 (10.79)
2015-16	-5.52 (3.72)	5.10 (7.7)	10.09 (10.87)	6.61 (8.5)	8.59 (9.94)

Source: Central Statistics Office, mospi.nic.in (within parentheses are all India figures)

Note: Sectoral GSVA together gives the GSVA at aggregate level

1.2 One of the factors that sustained the relatively high growth of the secondary (in particular construction) and tertiary (in particular trade, hotels etc) sectors in Kerala was the large inflow of remittances. According to the Development and Migration Brief (2017)' published by the World Bank, inward remittances to India dropped by 9 per cent from \$ 67 billion in 2015 to \$62.7 billion in 2016. While state- wise break up of remittances are not available, it may be safe to assume that Kerala must have faced a similar trend. The appreciation of the rupee would also have contributed to the fall in remittances in rupee terms affecting construction and trade, hotels and restaurants.

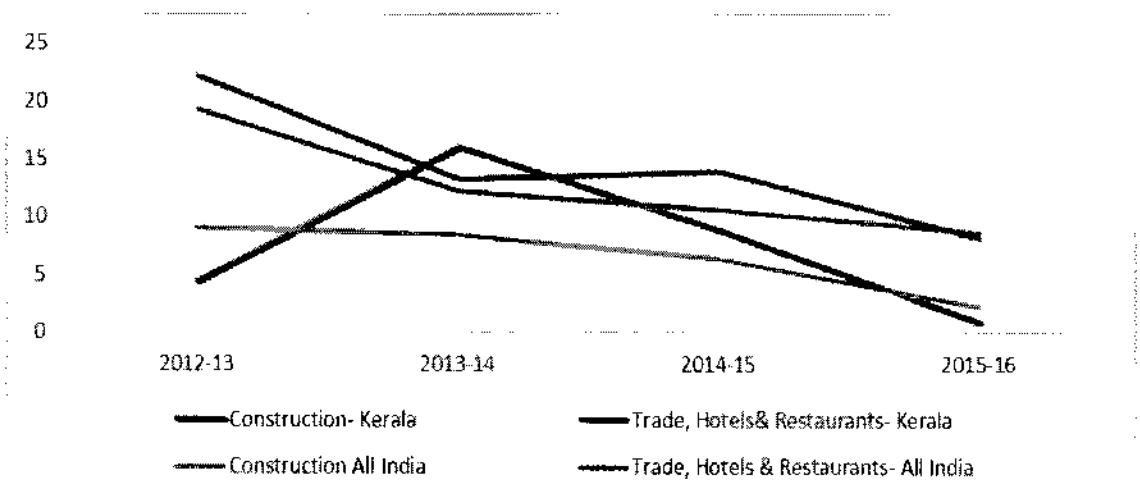
¹ . However, the growth rate of GSDP of Kerala in constant prices increased from 4.26 per cent in 2014-15 to 6.6 per cent in 2015-16. At the all-India level too, growth rate of GDP at constant prices increased from 7.5 per cent to 8.0 per cent during the same period.

Table 1.2: Growth Rates of Construction, Trade, Hotels and Restaurants: Kerala and all India- 2012-13 to 2015-16 (% per annum)

Year	Construction	Trade, Hotels and Restaurants
2012-13	4.43 (9.02)	22.19 (19.35)
2013-14	16.10 (8.46)	13.32 (12.30)
2014-15	8.97 (6.38)	14.00 (10.72)
2015-16	0.95 (2.29)	8.20 (8.72)

Source: Central Statistics Office, mospi.nic.in. (within parentheses are all India figures)

Figure 1.1: Growth Rates of Construction, Trade, Hotels and Restaurants : Kerala and all India : 2012-13 to 2015-16 (% per annum)



Source: Table 1.2

1.3 The decline in growth rate of GSDP makes it harder to meet the debt sustainability condition as it requires growth rate of the economy to be higher than the interest rate and a stable primary deficit. Given the level of primary deficit in Kerala, debt sustainability in the medium term can be a major challenge, if the difference between GSDP growth rate and interest rate start to narrow down. The gap between growth rate and interest rate known as Domar Gap in economic literature as projected in the Medium Term Fiscal Policy (MTFP) Statement, 2017, has considerably declined, as actual GSDP growth has been lower than the projections made in MTFP. Overall slowdown in growth rate and consistently

high primary deficit continue to be major challenges in fiscal management in the State (Table 1.3).

Table 1.3: Domar Gap: Projections in MTFP Statement 2017-18 and Actuals (% per annum)

Year	GSDP Growth Rate (MTFP Projections)	Actual GSDP Growth Rate	Nominal Interest Rate	Domar Gap (As per GSDP growth rate projections in MTFP)	Revised Domar Gap (Based on Actual GSDP Growth Rate)	Primary Deficit/GSDP Ratio (Actuals)
	1	2	3	4 (1-3)	5 (2-3)	6
2013-14	12.79	12.79	7.43	5.36	5.36	1.87
2014-15	13.11	10.22	7.68	5.43	2.54	1.73
2015-16	11.85	8.59	7.59	4.26	1	1.21

Source: MTFP statement, 2017-18, GOK, & mospi.nic.in

1.4 It is also important to note that the Domar Gap, though still positive, has significantly narrowed down in recent years (Table 1.3). If the decline in nominal GSDP growth rate continues and interest rates remain at the level projected in MTFP 2017, sustainability of debt would become a challenge in the medium term. This is especially so, as Primary Deficit is expected to persist till 2019-20, according to the MTFP statement 2017. In this context, addressing the twin challenges of Primary Deficit and formulating innovative steps to revive economic growth assumes significance.

1.2 State Finances- An Overview

1.2.1 An overview of State finances for the Financial Year 2015-16, reveals that Revenue receipts as a percentage of GSDP increased to 12.40 percent from 11.31 percent during 2014-15. This increase is due to the larger share of Central tax devolution and receipt of Revenue Deficit grants consequent to the implementation of 14th Finance Commission recommendations. (Table 1.4)

1.2.2 State's Own Tax Revenue (SOTR) was marginally higher at 7.01 percent of GSDP in 2015-16 as against 6.87 percent in 2014-15. This is in spite of the fact that growth rate of nominal GSDP has declined to 8.59 percent in 2015-16 from 10.22 percent in 2014-15 (Table 1.1). This implies that the buoyancy of Own Tax Revenue has gone up during 2015-16 (to 1.24 from 0.99 for 2014-15). In other words, its growth is higher than that of the nominal GSDP.

1.2.3 State's Own Non-Tax Revenue (SONTR) also showed a minor increase from 1.42 percent in 2014-15 to 1.51 percent of GSDP during 2015-16. Central transfers increased from 3.01 percent in 2014-15 to 3.88 percent of GSDP in 2015-16. However, the compositional shift of Central transfers during 2015-16 is noteworthy (Table 1.4). Central transfers have an untied and a tied part. In the case of the former, the States have the discretion to decide on areas and priorities of spending. Regarding the latter, the purpose for which they are to be utilised is laid down and the States have no control over the direction of spending though states have to make matching contribution to these schemes.

1.2.4 The components of Central transfers are a) share of Union taxes devolved to the states on the basis of the recommendations of Finance Commission, b) Grants disbursed under Article 275 of the Constitution by the Finance Commissions, c) Normal Central

Assistance for State Plans (discontinued since financial year 2017-18) and d) Central Share in Centrally Sponsored Schemes (CSS). Out of these, amounts received under tax sharing are completely flexible. As regards, the grants, General Purpose Grants for augmenting post-tax devolution revenue receipts of the States form part of the flexible component of Central transfers. But other Grants awarded by the Finance Commission for Local Self Governments (LSGs), Disaster Response and for other specific purposes, form part of the tied portion of Central transfers. The Normal Central Assistance for State Plans and Central Share for CSS are part of the tied portion of Central transfers.

1.2.5 Consequent to the 14th Finance Commission (FC) award, more untied fiscal space in the form of higher tax devolution has become available to the States. The share of States in Central taxes increased from 32 per cent to 42 percent of the divisible pool. The *inter se* share of Kerala too witnessed an increase from 2.34 per cent to 2.5 percent. Kerala also became eligible for Revenue Deficit grants amounting to a total of Rs.9559 crore for three financial years 2015-16, 2016-17 and 2017-18. During 2015-16, the amount of Revenue Deficit grant received by the State was Rs.4640 crore. It should be taken note of that Kerala did not receive any post tax devolution Non - Plan Revenue Deficit Grant (NPRD) during the 13th FC period.

1.2.6 At the same time, State Plan grants disappeared and grants for CSS substantially declined (Table 1.5). The untied part of Central devolution to Kerala went up by 118.66 percent, while the tied part has declined by 42.98 percent during 2015-16, when compared to 2014-15. Overall, the increase in Central Devolution is by 40.03 percent for Kerala during 2015-16 over that of 2014-15. (Table 1.5).

1.2.7 It may also be noted that the large increase in tied part of Central devolution in 2014-15 was due to the change in the accounting method of disbursement of grants through CSS. From 2014-15, the Central share of CSS has been routed through the state budgets. Prior to that these grants were released directly to the implementing agencies bypassing the state budgets. This, however, did not increase the fiscal space for the State, as only the method of transfer underwent a change. It is pertinent to note that even after this change, an amount of Rs.2511.70 crore was released directly to the implementation agencies during 2015-16, as Central share in CSS (Kerala Finance Accounts, 2015-16, Volume II, Page 66 Appendix VI).

1.2.8 On the expenditure side, Revenue Expenditure as a proportion of GSDP increased from 14.0 percent in 2014-15 to 14.14 percent in 2015-16, while the growth rate of Revenue Expenditure during the same period decelerated to 9.68 percent from 18.62 percent. The lower growth rate in Revenue Expenditure was due to a) shortfall of Rs.3869 crore in actual spending as against Budget Estimates in Non-Plan Revenue Expenditure and b) a similar shortfall in Plan Revenue expenditure amounting to Rs.2730 crore. The Non - Plan Revenue Expenditure growth declined to 8.37 percent as against an average growth rate of 20.17 percent during the previous four financial years. Besides, the Grants-in- Aid to Local Self-Governments (LSGs) declined by 39 percent during 2015-16 from the previous financial year. Over all, there has been short spending in 44 heads as pointed out by C & AG in Report No 2 of 2017 (See Table 3.2 of this report for sector- wise details).

1.2.9 However, a robust growth of 66.9 percent is recorded in 2015-16 under Capital Expenditure (CE). (details are discussed in Paragraph 3.2). The CE/GSDP ratio increased to 1.5 percent in 2015-16 from 0.97 percent in 2014-15.

1.2.10 The Revenue Deficit (RD) and Fiscal Deficit (FD) declined from 2.69 percent and 3.64 percent of GSDP respectively in 2014-15 to 1.73 percent and 3.20 percent of GSDP respectively in 2015-16. However, outstanding debt increased to 28.27 percent of GSDP from 26.42 percent during the same period (Table 1.4).

Table 1.4: Trends in Major Indicators of State's Finances: 2011-12 to 2015-16 (Rs.crore)

Items	2011-12	2012-13	2013-14	2014-15	2015-16
Revenue Receipts	38010	44137	49177	57950	69033
% of GSDP	10.44	10.7	10.57	11.31	12.40
State Tax Revenue	25719	30077	31995	35233	38995
% of GSDP	7.06	7.29	6.88	6.87	7.01
State Non-Tax Revenue (SNTR*)	2592	4199	5575	7284	8425
SNTR as % of GSDP	0.71	1.02	1.2	1.42	1.51
<i>Net receipts of Lotteries in SNTR</i>	381	591	593	960	1149
Central Govt. Transfers	9700	9862	11607	15434	21612
% of GSDP	2.66	2.39	2.5	3.01	3.88
Capital Receipts	12284	15685	17050	18719	17965
% of GSDP	3.37	3.8	3.67	3.65	3.23
Total Receipts	50295	59823	66227	76670	86998
% of GSDP	13.82	14.51	14.24	14.96	15.63
Total Expenditure	50896	59228	66244	76744	87032
% of GSDP	13.98	14.36	14.24	14.97	15.64
Revenue Expenditure	46045	53489	60486	71746	78689
RE as % of GSDP	12.65	12.97	13.01	14.00	14.14
<i>Expenditure on Lotteries in RE</i>	902	2083	3203	4485	5123
Capital Outlay	3853	4603	4294	4255	7500
% of GSDP	1.06	1.12	0.92	0.83	1.35
Loan Disbursements	999	1136	1464	743	842
% of GSDP	0.27	0.28	0.31	0.14	0.15
Revenue Deficit	8034	9351	11309	13796	9657
% of GSDP	2.21	2.27	2.43	2.69	1.73
Fiscal Deficit	12815	15002	16944	18642	17818
% of GSDP	3.52	3.64	3.64	3.64	3.2
Primary Deficit	6521	7798	8679	8872	6708
% of GSDP	1.79	1.89	1.87	1.73	1.21
Outstanding Debt	89418	103561	119009	135440	157370
% of GSDP	24.56	25.12	25.59	26.42	28.27
GSDP (Current Prices)	364048	412313	465041	512564	556616

Source: Budget in Brief, GoK, various issues, Finance Accounts, C&AG various issues & mospi.nic.in

Note *SNTR includes Gross Receipts from Lotteries. The Net Receipts from lotteries (Gross- Expenditure) is shown in the next row and expenditure on Lotteries is given below the row in which Revenue Expenditure as percentage of GSDP is shown .

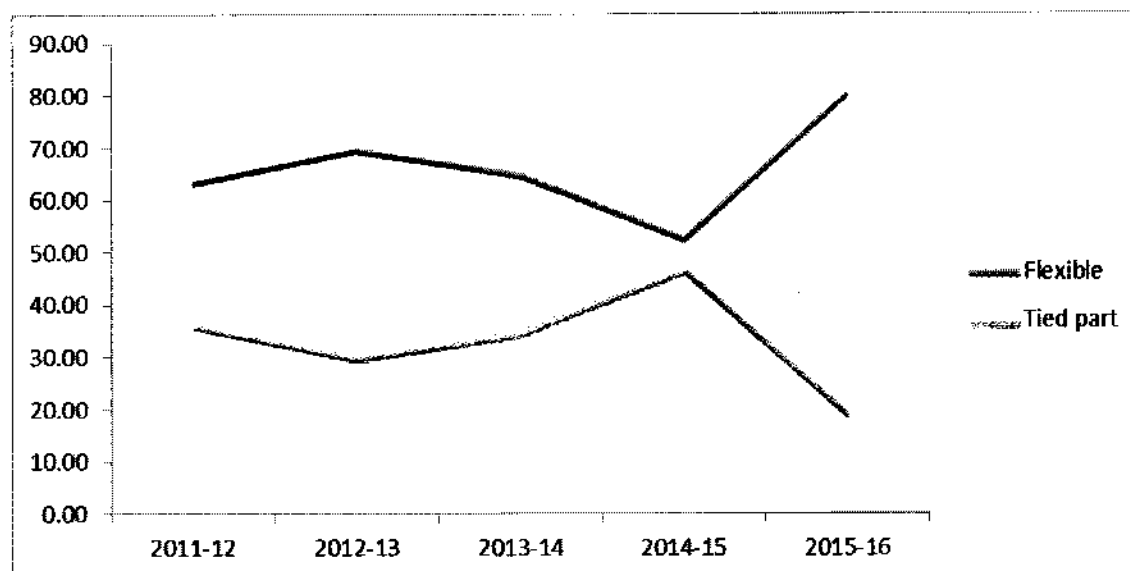
Table 1.5: Structural Changes in Composition of Central Transfers to Kerala : Pre and Post 14th Finance Commission

A. Components of Central Transfers (Rs Crore)										
Year	Central Tax Devolution	Finance Commission Grants		Nonplan Grants other than FC	State Plan Grants	Central Share of CSS	Total Central Transfers	Flexible Part	Tied Part	Year to Year Net Increase
		General Purpose Grant (2a)	Special Purpose Grant (2b)							
	(1)	(2)		(3)	(4)	(5)	(6) =1+ 2a+ 2b+3 +4+5	(7)= 1+2a	(8) = 2 b+ 3 + 4+5	(9)
2011-12	5990	0	1174	259	904	1372	9699	5990	3709	—
2012-13	6841	0	601	57	1163	1201	9863	6841	3022	164
2013-14	7469	0	1568	111	1154	1305	11607	7469	4138	1744
2014-15	7926	0	1574	410	1555	3969	15434	7926	7508	3827
2015-16	12691	4640	531	6	60	3684	21612	17331	4281	6178
B. Shares (% per annum)										
Central Tax Devolution	FC General Purpose Grants	FC Specific Purpose Grants	Non Plan Grants other FC	State Plan Grants	Central Share in CSS	Share of Flexible Part	Share of Tied Part			
61.76	0	12.1	2.67	9.32	14.15	61.76	38.24			
69.36	0	6.09	0.58	11.79	12.18	69.36	30.64			
64.35	0	13.51	0.96	9.94	11.24	64.35	35.65			
51.35	0	10.2	2.66	10.08	25.72	51.35	48.65			
58.72	21.47	2.46	0.03	0.28	17.05	80.19	19.81			
C. Growth Rates (%per annum)										
	Growth Rate Total Central Transfers		Growth rate of Flexible Part			Growth Rate of Tied Part				
2012-13	1.69		14.21			-18.52				
2013-14	17.68		9.18			36.93				
2014-15	32.97		6.12			81.44				
2015-16	40.03		118.66			-42.98				

Source: Budget in Brief, GOK, various issues

Note: The tied part does not include the amount of Rs.2511.70 crore directly released to implementation agencies.

Figure 1.2: Composition of Flexible and Tied part of Central Devolution to Kerala: 2011-12 to 2015-16



Source: Table 1.5

Changing Composition of Central Transfers – Implications for Immediate Future

1.2.11 From 2017-18, Central Assistance to State Plan has been discontinued, as Centre has done away with Five Year Plans. For Kerala, the Revenue Deficit grants, which helped in containing Revenue Deficit, even in the face of stagnant Own Tax Revenue growth, would not be available from the financial year 2018-19.

1.3 Deficit Indicators of the State

1.3.1 The Revenue Deficit of the state declined by 32 percent during 2015-16 to Rs.9656.81 crore from Rs.13995.96 crore in 2014-15. This was mainly due to a) higher Central devolution and b) substantially lower Revenue Expenditure than the budget estimate. The RD to FD ratio also declined to 54.20 percent in 2015-16 as against 74 percent in 2014-15, making more resources available for capital expenditure. The FD/GSDP ratio declined to 3.20 percent in 2015-16 from 3.64 percent in 2014-15.

1.4 Fiscal Consolidation Trends and Targets in Kerala Fiscal Responsibility and Budget Management (KFRBM) Act, 2003.

1.4.1 The 13th Finance Commission gave State specific targets for Deficit and Debt reduction up to the period ending 2014-15. Accordingly, the KFRBM Act, 2003 was amended in 2011, incorporating the targets to be achieved by 2014-15. The RD which was to be eliminated by 2014-15, was at 1.73 percent of GSDP in 2015-16. FD target of 3 percent of GSDP, which was to be achieved by 2013-14 has also been breached. The only indicator that could stay within the limit recommended by 13th FC was debt/GSDP ratio. It was at 28.27 percent as against 29.8 percent recommended by the 13th FC for 2014-15.

1.5 Implications of Recommendations of FRBM Review Committee 2017

1.5.1 The rule based fiscal control regime has fundamentally changed after the recommendations of the 14th Finance Commission. Union Budget, 2017-18, based on the recommendations of the FRBM Review Committee has argued that sustainable debt path should be the macroeconomic anchor of our fiscal policy. "The Committee has favoured a Debt to GDP ratio of 60 percent for the overall Government (Union and the States together) by 2023, consisting of 40 percent for Central Government and 20 percent for State Government. Within this framework, the Committee has derived and recommended 3 percent fiscal deficit for the next three years. The Committee has also provided for 'Escape Clauses', for deviations upto 0.5 percent of GDP, from the stipulated fiscal deficit target. Among the triggers for taking recourse to these Escape Clauses, the Committee has included "far-reaching structural reforms in the economy with unanticipated fiscal implications" as one of the factors".

1.5.2 This budget announcement should be studied in the light of the fiscal roadmap laid out by the Fourteenth Finance Commission (FFC). The deficit path in case of States, as recommended by the FFC, has provided a flexibility of upto 0.5 percent of GSDP under following conditions: (a) zero revenue deficit, (b) fiscal deficit not exceeding 3 percent of GSDP, (c) interest payment to revenue receipt ratio not exceeding 10 percent, and (d) debt-GSDP ratio below 25 percent. In FFC's assessment of Union and State finances, combined Debt to GDP ratio needs to be brought down to 58.24 percent of GDP by the end of 2019-20. The debt adjustment path proposed by the FFC provides for an increase in the Debt-GDP ratio of all States from 21.90 percent to 22.38 percent. At an aggregate level, State debt to GDP ratio for the year 2016-17 (BE) stood at 22 percent, well within the target set by the FFC. State specific debt to GSDP ratio is shown in Table 1.6.

Table 1.6: Debt - GSDP ratio of Major States (%of GSDP)

States	2014-15	2015-16 RE	2016-17 BE
Andhra Pradesh	22.9	24	24
Bihar	25.8	25.2	25.3
Chhattisgarh	14	15.2	15.5
Goa	27.2	28.9	30.6
Gujarat	24.6	24.2	23.3
Haryana	20.5	21.5	21.3
Jharkhand	21.9	21.2	20.9
Karnataka	22.6	22.5	24.1
Kerala	26.42	28.5	28.1
Madhya Pradesh	22.2	21.5	20.3
Maharashtra	20.5	20.5	20.1
Orissa	18.5	19.1	18.8
Punjab	32.2	32.4	31.4
Rajasthan	24.8	25.8	26
Tamil Nadu	21	21	21.2
Uttar Pradesh	30.9	30.5	30.1
West Bengal	36.7	35.5	32.9
All States	21.9	22.3	22

Source: Budget documents of respective State Governments

1.5.3 In case of Union Government, the FFC recommended a larger correction in Debt to GDP ratio, and the correction is expected from 43.60 percent in 2015-16 to 36.30 percent in 2019-20. This asymmetric correction path is primarily to ensure fiscal discipline for the Union Government, given large deficit and debt (above the FRBM target) at the Central level since 2009 (Table 1.7).

Table 1.7: Consolidated Fiscal Roadmap Recommended by the FFC (% of GDP)

item	2015-16	2016-17	2017-18	2018-19	2019-20
Debt Stock-Union	43.6	41.41	39.49	37.79	36.3
Debt Stock- States	21.9	22.06	22.21	22.3	22.38
Outstanding Union Loan to States	0.97	0.81	0.66	0.54	0.44
Consolidated Outstanding Debt	64.53	62.67	61.03	59.55	58.24

Source: Report of the Fourteenth Finance Commission

1.5.4 With the FFC recommendation in hindsight, it is pertinent to acknowledge that if the FRBM paths proposed upto 2023 for both Union and States are to be adhered to, the States may have to undertake larger fiscal correction than what is envisaged in the FFC Report. It is also to be noted that at the level of all states, for 2015-16 (RE) and 2016-17 (BE), due to larger fiscal expansion consequent to the introduction of UDAY scheme, and impending Pay Commission awards, adherence to deficit targets has suffered a set back. Additionally, the restructuring of financing pattern of Centrally Sponsored Schemes and other transfers from the Centre to the states have also placed a larger burden on the States. While this has reduced the quantum of transfers flowing to the states as per cent of GDP (as discussed above), it has placed an asymmetric burden on the States to meet the newly announced overall fiscal prudence targets. On the other hand, if the Centre manages to follow the fiscal consolidation path laid in the FFC Report, it can comfortably meet the 40% Debt to GDP ratio target by the year 2023.

1.5.5 Though targeting debt as a policy anchor instead of deficit has been suggested, the realisation of the new fiscal prudence targets would depend a lot on the real GDP growth rate, rate of inflation, level of deficit and the interest rate. Additionally, the question of how exactly will the States manage to achieve the 20 percent Debt to GDP ratio by the year 2023, in the event of rising expenditures and falling revenues, is worth deliberating upon, if the consolidated 60 percent debt to GDP target is to be attained for perceived prudent fiscal management at the macro level. A review of the recommendations of the FRBM Committee and its implications on Kerala finances forms the content of Chapter 5 of this report.

Chapter 2

Review of Revenue Receipts

2.1 Revenue Receipts – Structure and Trends

2.1.1 Total Revenue Receipts during 2015-16 were Rs.69033 crore, as against Rs.57950 crore in 2014-15, recording an annual growth rate of 19.12 percent. The State's Own Tax Revenue (SOTR) was Rs.38995 crore during 2015-16 as against Rs.35232 crore in 2014-15, with an annual growth rate of 10.68 percent. Growth rate of SOTR continued to be moderate when compared to the period from 2006-07 to 2012-13 (Table 2.2, page 18 of the First Report of this Committee). As is evident from Table 2.1, the slowdown in growth rate of SOTR receipts and its major components started in the financial year 2013-14 and continued thereafter. Table 2.1 gives the details of collection, growth and share of Own Tax Revenue by major components.

Table 2.1: Trends in Own Tax Revenue: 2011-12 to 2015-16

A. Own Tax Revenue by Major Components (Rs. crore)						
Year	Sales Tax/VAT	Excise duty	Motor vehicle tax	Stamp duty and Registration	Others	Own Tax Revenue
2011-12	18939	1883	1587	2987	323	25719
2012-13	22511	2314	1925	2938	389	30077
2013-14	24885	1942	2161	2593	414	31995
2014-15	27908	1777	2365	2659	523	35232
2015-16	30737	1964	2814	2878	602	38995
B. Shares (%)						
Year	Sales Tax/VAT	Excise duty	Motor vehicle tax	Stamp duty and Registration	Others	Own Tax Revenue
2011-12	73.64	7.32	6.17	11.61	1.26	100.00
2012-13	74.84	7.69	6.40	9.77	1.29	100.00
2013-14	77.78	6.07	6.75	8.10	1.29	100.00
2014-15	79.21	5.04	6.71	7.55	1.48	100.00
2015-16	78.82	5.04	7.22	7.38	1.54	100.00
C. Growth Rates (%)						
2011-12	19.62	10.76	19.23	17.05	5.56	18.40
2012-13	18.86	22.89	21.30	-1.64	20.43	16.94
2013-14	10.55	-16.08	12.26	-11.74	6.43	6.38
2014-15	12.15	-8.50	9.44	2.55	26.33	10.12
2015-16	10.14	10.52	18.99	8.24	15.11	10.68

Source: Finance Accounts, C&AG, various issues

2.1.2 The Sales Tax/VAT, the largest component of SOTR grew at 10.14 percent during 2015-16 as against 12.15 percent in 2014-15. Commodity wise trends in growth of Sales Tax/VAT for the period 2011-12 to 2015-16 have been discussed in detail in Chapter 2 of the First Report of this Committee. As observed in the First Report, there was discernible downward trend in growth rate of revenue from all major commodities during 2013-14 to 2015-16.

2.1.3 The State Excise Duty collections (levied on alcoholic liquor for human consumption) grew at 10.52 percent over the previous year's negative growth rate of 8.50 percent. The

policy decision of the State government since 2013-14, to stop selling Indian Made Foreign Liquor (IMFL) through licensed bars and, phasing out of the retail outlets of Kerala State Beverages Corporation (KSBC) in the State has had an adverse impact on collections under this head.

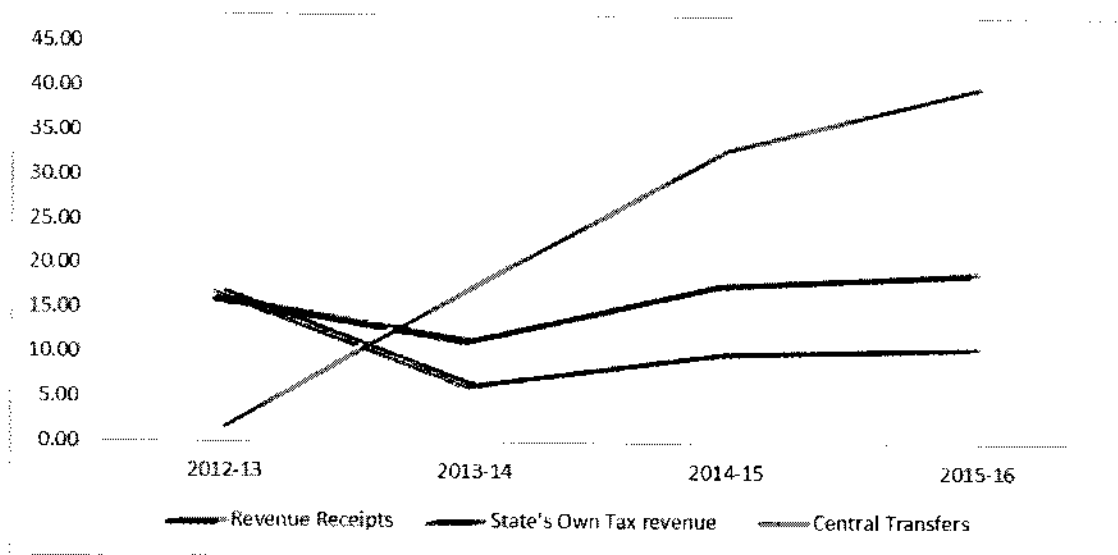
2.1.4 Motor Vehicle tax grew at 18.99 percent in 2015-16 in contrast to 9.44 percent in 2014-15. The growth in revenue collection from Stamp Duty and Registration Fees was higher at 8.24 percent in 2015-16 as against a subdued 2.55 percent during 2014-15. The growth rate of "Others" component declined from 26.33 percent to 15.11 percent during the same period. Thus, apart from Motor Vehicle Tax, State Excise Duty and Stamp Duty and Registration Fees, growth rates of all other components declined during 2015-16 when compared to 2014-15, resulting in lower growth rate of SOTR in 2015-16. However, the overall Revenue Receipts grew at 19.13 percent due to higher Central Transfers.

Table 2.2: Structure of Revenue Receipts of Kerala: 2011-12 to 2015-16

Item	2011-12	2012-13	2013-14	2014-15	2015-16
A. Revenue Receipts by Components (Rs crore)					
Revenue Receipts	38010	44137	49177	57950	69033
State's Own Tax Revenue (SOTR)	25719	30077	31995	35233	38995
State's Own Non-Tax Revenue (SONTR)	2592	4199	5575	7284	8425
Central Transfers	9700	9862	11607	15434	21612
B. Shares (% per annum)					
State's Own Tax Revenue (SOTR)	67.66	68.14	65.06	60.80	56.49
State's Own Non Tax Revenue (SONTR)	6.82	9.51	11.34	12.57	12.20
Central Transfers	25.52	22.34	23.60	26.63	31.31
	100	100	100	100	100
C. Growth Rates (% per annum)					
Revenue Receipts		16.12	11.42	17.84	19.13
State's Own Tax Revenue (SOTR)		16.94	6.38	10.12	10.68
State's Own Non-Tax Revenue (SONTR)		62.00	32.77	30.65	15.66
Central Transfers		1.67	17.69	32.97	40.03

Source: Finance Accounts, C&AG, various issues

Figure 2.11: Growth Rates of Revenue Receipts, State's Own Tax Revenues and Central Transfers 2012-13 to 2015-16



Source: Table 2.2

2.1.5 It is evident from Table 2.2 that the share of Central Transfers increased to 26.63 percent in 2014-15 from 23.60 percent in 2013-14 and further to 31.31 percent during 2015-16. As already discussed in Chapter 1 of this report, the increase in the share during 2014-15 was due to the process of re-routing release of Central grants through the State budget, instead of directly to implementing agencies. Another contributing factor is the increase in tax share consequent to the award of the 14th Finance Commission.

2.2 Tax Effort

2.2.1 It can be seen from Table 2.3 that the actual collections of Own Tax and Non-Tax Revenues have fallen short of Budget Estimates (BE) and Revised Estimates (RE) during 2015-16. The Central Transfers too have been overestimated in BE and RE for 2015-16, as can be seen from the shortfall in actuals. Margins of errors differed across sources of revenues.

Table 2.3: Budget Estimates, Revised Estimates and Actual Revenue Receipts 2015-16

Item	Budget Estimate (BE) (Rs crore)	Revised Estimate (RE) (Rs crore)	Actuals (Rs crore)	Actuals to BE (%)	Actual to RE (%)
Own Tax Revenue	45428	39881	38995	85.84	97.78
Own Non - Tax Revenue	8931	8911	8425	81.56	81.74
Central Tax Devolution	13122	13122	12691	96.72	96.72
Central Grants	9946	9105	8921	89.69	97.98

Source: Budget in Brief, GOK, various issues

2.3 Revenue Receipts- Challenges in the immediate future

2.3.1 Besides, tapering off of Revenue Deficit grants, the State faces certain additional challenges in achieving a robust growth of Revenue Receipts. These are the impacts of demonetisation on tax base and issues arising from implementation of Goods and Services Tax (GST).

2.3.2 It is now an accepted fact that post demonetisation there has been a slowdown in economic growth, both at the all India and the State level. Demonetisation or the withdrawal of currency notes of Rs.500/- and Rs.1000/- denominations from circulation on November 8, 2016, took out 86 percent of the value of currency in circulation. Obviously, all economic activity and particularly cash dependent sectors, like construction, trade and units in the informal sector contracted severely. This is palpable from deceleration of growth rate of collection of Own Tax Revenue in Kerala, before and immediately after demonetisation in Kerala (Table 2.4). It can be seen that growth rate from all components of Own Tax Revenue, except Excise duties on alcoholic liquor for human consumption and Motor Vehicle Tax, was negative immediately after demonetisation (Table 2.4). This would obviously slowdown the growth rate of Own Tax Revenue in financial year 2016-17.

Table 2.4 Growth Rates of Own Tax Revenue in Kerala: Pre and Post demonetisation (%)

Item	July- October 2016 (Pre demonetisation)	November- December 2016 (Post demonetisation)
Commercial Taxes	1.94	-8.5
Excise	5.3	3.63
Registration	5.9	-7.48
Motor Vehicles	4.4	2.46
Total	2.1	-7.63

Source: Table 19 Report of the Committee to Study Impact of Demonetisation on the State Economy of Kerala-, February 2017

2.3.3 Since the implementation of GST from 1st July 2017, the standard rate on goods, which was 14.5 percent under the Value Added Tax (VAT) regime, has come down to 9 percent (SGST component of 18 percent GST). This implies that there has been a fall in the rate of tax by 5.5 percent for a majority of commodities (14.5 - 9), as 75 percent of the taxable commodities were at 14.5 per cent under the VAT. Though tax on supply of services has become part of States' revenue, the general economic slowdown trends along with implementation issues have impeded any buoyant growth of tax revenues. However, on the positive side 14 percent annual growth rate of taxes subsumed in GST (based on actual collections of 2015-16) is assured under the post- GST scenario for five financial years beginning from 2017-18. Hence, from 2017-18 to 2021-22, baseline growth of 14 percent is assured with regard to State taxes subsumed in GST and this is higher than the average growth rate of tax collections during 2013-14 to 2016-17, under the pre-GST regime.

Chapter 3

Review of Revenue and Capital Expenditures

3.1 Revenue Expenditure- Structure and Trends

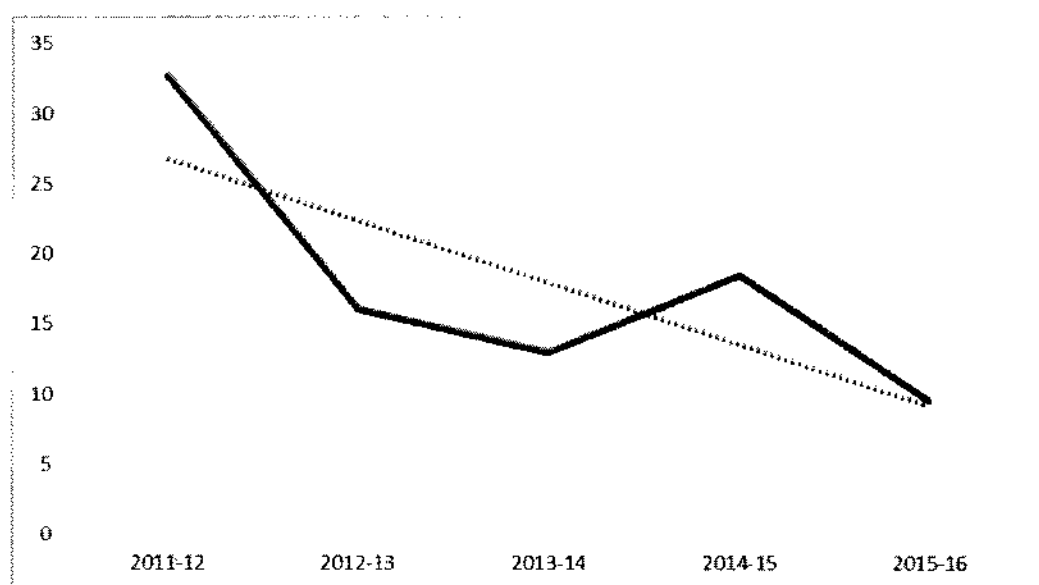
3.1.1 Out of the aggregate expenditure of the State of Rs.87,032 crore in 2015-16, Revenue Expenditure component was Rs.78,689 crore constituting 90.14 percent of the total as against 93.49 percent in 2014-15. Though there is a decline in the share of revenue expenditure in total expenditure, it is still higher when compared with the all States' average of 80.86 percent.

3.1.2 Table 3.1 presents growth rates of the major components of Revenue Expenditure from 2011-12 to 2015-16. Overall, the growth rate of Revenue Expenditure declined to 9.68 percent in 2015-16 from 18.62 percent in 2014-15. Except for Social services, the growth rate of all other major components declined, with Grants-in-Aid to LSGs showing an absolute decline of 39 percent compared to an increase of 28.71 percent in 2014-15. Growth rate of Revenue Expenditure in Economic services and General services declined to 8.84 and 14.8 percent respectively during 2015-16 from 28.6 and 18.14 percent respectively in 2014-15, while that for Social services increased to 16.38 percent during 2015-16, from 11.14 percent in 2014-15. (Table 3.1). The sectoral shares have more or less remained the same, except for Grants-in-Aid to LSGs. There was an abnormally high growth rate in Revenue Expenditure and its components during 2011-12, when the Ninth Pay Commission recommendations were implemented. But a similar high growth in Revenue Expenditure was not witnessed in 2015-16, when the Tenth Pay Commission's recommendations were implemented. This is due to the fact that the notification was issued only towards the end of the financial year 2015-16 and substantial actual disbursements started only in the subsequent financial years.

Table 3.1: Structure of Revenue Expenditure: 2011-12 to 2015-16

Year	General Services (%)	Social Services (%)	Economic Services (%)	Grants in Aid to LSGs (%)	Revenue Expenditure (Rs crore)
2011-12	44	35	13	8	46045 (100)
2012-13	43	35	15	7	53489 (100)
2013-14	44	35	13	8	60486 (100)
2014-15	44	33	14	9	71748 (100)
2015-16	46	35	14	5	78689 (100)
Growth Rates (% per annum))					
Year	General Services	Social Services	Economic Services	Grants in Aid to LSGs	Revenue Expenditure
2011-12	31.66	33.96	40.81	21.99	32.83
2012-13	12.25	16.36	27.35	18.5	16.17
2013-14	16.76	11.14	1.55	23.78	13.08
2014-15	18.14	13.06	28.6	28.71	18.62
2015-16	14.8	16.38	8.84	-39.00	9.68

Source: Finance Accounts, C&AG, various issues

Figure 3.1: Growth rate of Revenue Expenditure - 2011-12 to 2015-16 (%)

Source: Table 3.1

Table 3.2: Budget Estimates (BE), Revised Estimates (RE) and Actuals of Revenue Expenditure components: 2015-16

Item	BE (Rs.crore)	RE (Rs.crore)	Actual (Rs.crore)	Actuals as a proportion of BE (%)	Actuals as a proportion of RE (%)
Total Revenue Expenditure	85259	81834	78689	92.29	96.16
Plan Revenue Expenditure	14809	12264	12079	81.57	98.49
(a)CSS	7064	5459	3762	53.26	68.91
(b)State	7745	6805	8317	107.39	122.22
Non - Plan Revenue Expenditure	70450	69570	66610	94.55	95.75
Salaries	26594	23236	23450	88.18	100.92
Pension	13172	13126	13063	99.17	99.52
Interest payments	10952	10861	11111	101.45	102.30
Devolution to LSGs	7665	6493	5029	65.61	77.45
Others	12067	15854	13957	115.66	88.03

Source: Finance Accounts, C&AG, various issues

3.1.3 Table 3.2 shows that the actuals have varied by wide margins from Budget Estimates and the variation has been higher for Plan Revenue Expenditure, Grants-in Aid to LSGs and CSS. The variation between BE and actuals for salary is (-) 13.06 percent, while RE has been closer to actuals. The BE and RE of other committed expenditure items of Pension and Interest payments have been close to actuals. The reason for decline in Grants-in-Aid to LSGs is that the State government introduced bill system, that is, drawing of funds based on actual expenditure incurred, instead of periodic withdrawals and parking the unspent

balances in the accounts of the authorised LSG officials. The probable reason for variation in CSS is that the pattern of Central financing changed during the financial year and could not be adequately foreseen at the time of budget exercise. The lower actual figures as against Budget Estimates under these two heads, has been the main reason for lower Revenue Expenditure growth during 2015-16.

3.2 Trends in Salary, Pensions and Interest

3.2.1 As regards the fall in expenditure under salaries and pension, it has to be noted that Budget Estimate 2015-16 included provision for additional commitment towards pay and pension revision, and arrears to be paid. But the order implementing pay revision was issued only on 20/1/2016, that is, towards the end of the financial year 2015-16, pushing the fiscal burden of Tenth Pay Commission award to subsequent financial years. But this shortfall in 2015-16 would result in substantial additional commitments towards implementation of Pay Commission award during financial years 2016-17, 2017-18 and 2018-19. This is evident from the fact that the salaries/TRE ratio, which was 29.87 per cent for the years 2014-15 and 2015-16, increased to 30.84 per cent in 2016-17 as per the provisional accounts prepared by the Accountant General. This would cause additional fiscal stress, especially when RD grants awarded by 14th FC also would taper off and cease by 2018-19.

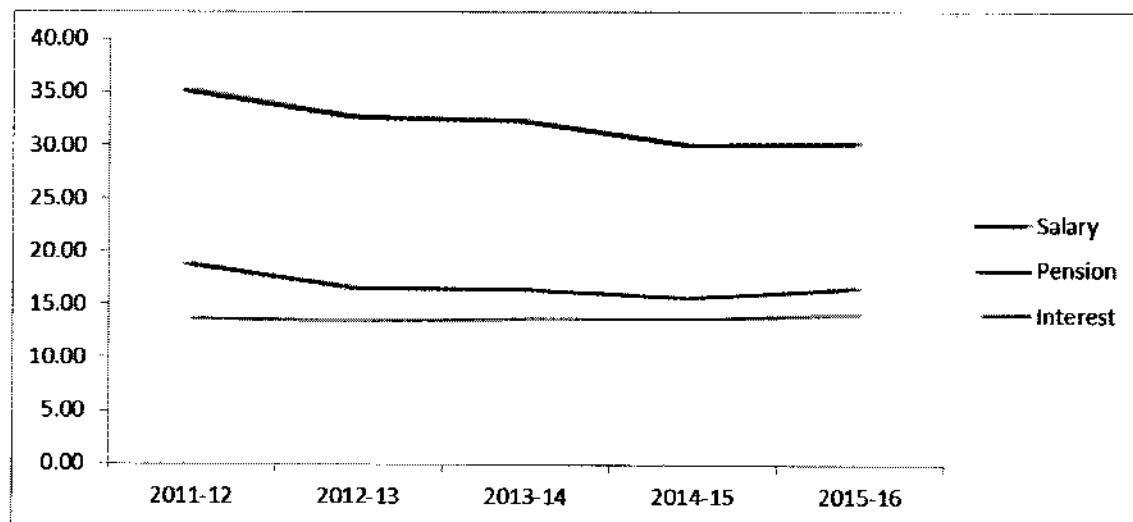
Table 3.3: Trends in Salary, Pensions and Interest: 2011-12 to 2015-16

(Rs. crore)

Year	Salary	Interest	Pensions	Revenue Expenditure
2011-12	16029	6294	8700	46045
2012-13	17257	7205	8867	53489
2013-14	19280	8265	9971	60486
2014-15	21344	9770	11253	71746
2015-16	23450	11111	13063	78690
Shares of Salary, Pension and Interest to Revenue Expenditure (per cent)				
2011-12	35.25	13.67	18.89	67.81
2012-13	32.73	13.47	16.58	62.77
2013-14	32.33	13.66	16.48	62.48
2014-15	30.14	13.62	15.68	59.44
2015-16	30.19	14.12	16.6	60.91

Source: Finance Accounts, C & AG, various issues

Figure 3.2 Trends in share of Salary, Interest and Pension in Revenue Expenditure: 2011-12 to 2015-16



Source: Table 3.3

3.3 Trends in Grants –in –Aid to LSGs

3.3.1 Another major expenditure item under which saving occurred is devolution to LSGs. Till 2014-15, the devolution of funds to LSGs were released in monthly instalments and were credited in their Treasury Savings Bank (TSB) accounts, from which expenditure could be met as and when claims arise and balance parked in the same account. From 2015-16, this method of release of grants was changed considering the increase in unspent balances in the TSB accounts with the LSGs. However, directions were issued vide G O (P) No 119/2015/Fin dated 21.03.2015, that the unspent balance would not lapse and would be made available to LSGs through Supplementary Demands for Grants (SDGs) in the subsequent financial year. The result of the above change in procedure resulted in spending of only of Rs.3903 crore during 2015-16, and a shortfall of Rs.2636 crore under the head of Grants-in-Aid to LSGs. But these would reflect as expenditure commitments in the next financial year, as per the Government Order (G.O) cited above if Supplementary Demands for Grants are placed subsequently.

3.4 Trends in Allocation for Centrally Sponsored Schemes (CSS)

3.4.1 Based on the recommendations of the Sub group of Chief Ministers on rationalisation of CSS, the Schemes have been categorised under Core of the Core, Core and Optional Schemes with change in Central and State share in financing pattern. It is now 90:10 for Core of Core, 60:40 for Core and 50:50 for Optional Schemes. This re-categorisation is one of the major reasons for the decline in fund flow to Kerala in 2015-16 when compared to 2014-15. List of some Programmes/Schemes for which assistance was reduced in 2015-16 are shown in Table 3.4

Table 3.4: Major CSS Schemes and Releases from the Centre to Kerala (Rs.crore)

Item	2014-15	2015-16
1. National Food Security Mission	3.12	0.76
2. RKVY	300.7	90.48
3. Swachh Bharat Abhiyan	33.97	8.5
4. National Rural Livelihood Mission	63.61	28.58
5. National AIDS&STD Control Programme	24.99	21.38
6. Umbrella ICDS	247.26	0
7. National Health Mission	540.38	316.58
8. MG NREGA	1587.58	1161.36
9. National Social Assistance Programme	104.9	152.05
10. National Programme of Mid-Day meals in Schools	225.75	171.21

Source: PFMS portal of Gol

Note:- Out of these, Sl. No 8 and 9 are Core of Core Schemes and all others are Core Schemes.

3.5 Trends in Subsidies

3.5.1 As far as explicit subsidies are concerned, it is 0.23 percent of GSDP for 2015-16 as against 0.24 percent for 2014-15. As can be seen from the Table 3.7 of the first report of this committee (extracted below), subsidies as a proportion of GSDP have been coming down. Out of the total subsidy of Rs.1372.89 crore during 2015-16, 81 percent, amounting to Rs 1106.35 crore is food subsidy. The trends in subsidies for the period 2011-12 to 2015-16 are discussed in paragraph 3.8 of the First Report of this Committee. The relevant portion is reproduced below.

"The major subsidy given by the State government is in the food sector. This includes amounts given to Kerala State Civil Supplies Corporation for market intervention. Other components of subsidies include power, irrigation, tourism, and education".

Table 3.5: Trend in Subsidies: 2011-12 to 2015-16

Year	Total Subsidy (Rs crore)	Food (Rs crore)	Power (Rs crore)	Others (Rs crore)	Subsidy as a proportion of GSDP (%)	Food subsidy as a proportion of Total Subsidy (%)
2011-12	1014.43	699.57	54.60	260.26	0.28	69
2012-13	1267.18	894.96	75.00	297.22	0.31	71
2013-14	1278.98	903.00	150.00	225.98	0.28	71
2014-15	1252.51	1026.57	50.00	175.94	0.24	82
2015-16	1372.39	1106.35	0.00	266.04	0.23	81

Source: First Report of the KPERC, August 2017

3.5.2 To sum up, revenue expenditure of the State will have to face the following challenges in the near future:

- a) Increased allocation for pay/pension revision commitments and arrear payments in 2016-17, 2017-18 and 2018-19.
- b) Non-availability of RD grants from 2018-19
- c) As funds unspent by the LSGIs during a particular financial year are again allotted through Supplementary Demands for Grants (SDGs) in the next financial year, there would be additional expenditure commitment during the next financial year.
- d) Increase in State's contribution to CSS due to the restructuring of financing of grants by Union government.

3.5.3 In short, the decrease in the growth of revenue expenditure during 2015-16 was not because of any medium term improvement or reduction in commitments. There is every likelihood of revenue expenditure increasing during 2016-17 and 2017-18. Committed part of the expenditure is downwardly inflexible, at least in the short run. Expenditure cuts with adverse impact on poorer sections of the society are also not socially and politically feasible. Under these circumstances, prudent management of State finances would mean prioritising expenditures.

3.6 Capital Expenditure

3.6.1 Capital Expenditure had recorded a very low growth rate of 0.33 percent during 2013-14 when compared with 18.30 percent during 2012-13. It decelerated to -13.21 percent during 2014-15 before recording a high growth rate of 66.92 percent during 2015-16. The increase in growth rate was on account of increase in expenditure in all the three sectors, namely General, Economic and Social Services. Among the components, the share of Economic services is predominant, followed by Social services, Loans and Advances and General services (Table 3.6). The growth rate of Capital Expenditure during 2015-16 was impressive. The actual expenditure was 91.17% of Budget Estimates and 117.08 % of Revised Estimates. (Table 3.7)

Table 3.6: Capital Expenditure – Sectoral Distribution: 2011-12 – 2015-16

A. Capital Expenditure by Components (Rs. Crore)					
Item	2011-12	2012-13	2013-14	2014-15	2015-16
General Service	162.34	146.91	148.04	134.66	256.60
Social Services	594.88	561.89	617.12	875.26	1035.03
Economic Services	3095.70	3894.49	3529.17	3244.67	6208.41
Loans and Advances	998.54	1136.15	1464.17	743.09	842.25
Total Capital Expenditure	4851.46	5739.44	5758.50	4997.68	8342.29
B. Shares (% per annum)					
General Service	3.35	2.56	2.57	2.69	3.08
Social Services	12.26	9.79	10.72	17.51	12.41
Economic Services	63.81	67.85	61.29	64.92	74.42
Loans and Advances	20.58	19.80	25.43	14.87	10.10
Total	100.00	100.00	100.00	100.00	100.00
C. Growth Rates (% per annum)					
General Service		-9.50	0.77	-9.04	90.55
Social Services		-5.55	9.83	41.83	18.25
Economic Services		25.80	-9.38	-8.06	91.34
Loans and Advances		13.78	28.87	-49.25	13.34
Total		18.30	0.33	-13.21	66.92

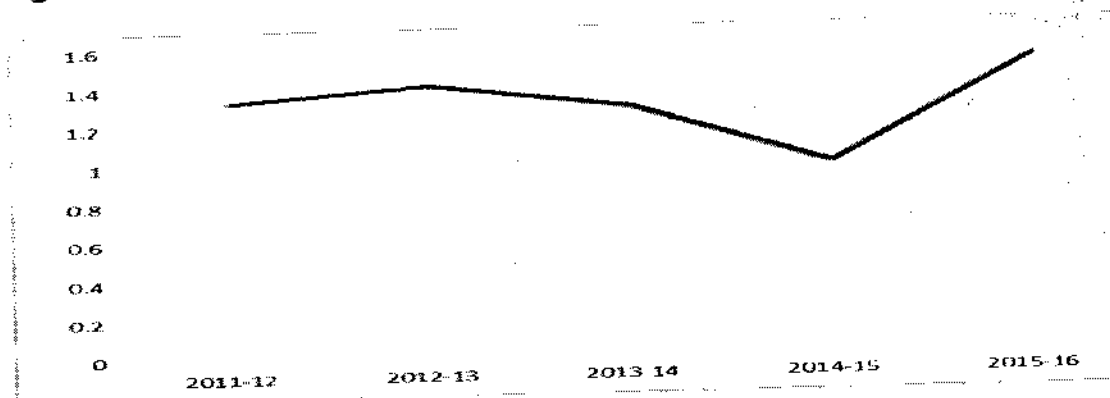
Source: Finance Accounts, C & AG, various issues

Table 3.7 Variations of BE, RE and Actual Capital Expenditure- 2015-16

BE (Rs crore)	RE (Rs crore)	Actual (Rs crore)	Actual/BE (%)	Actual/RE (%)
10066	7125	8342	91.17	117.08

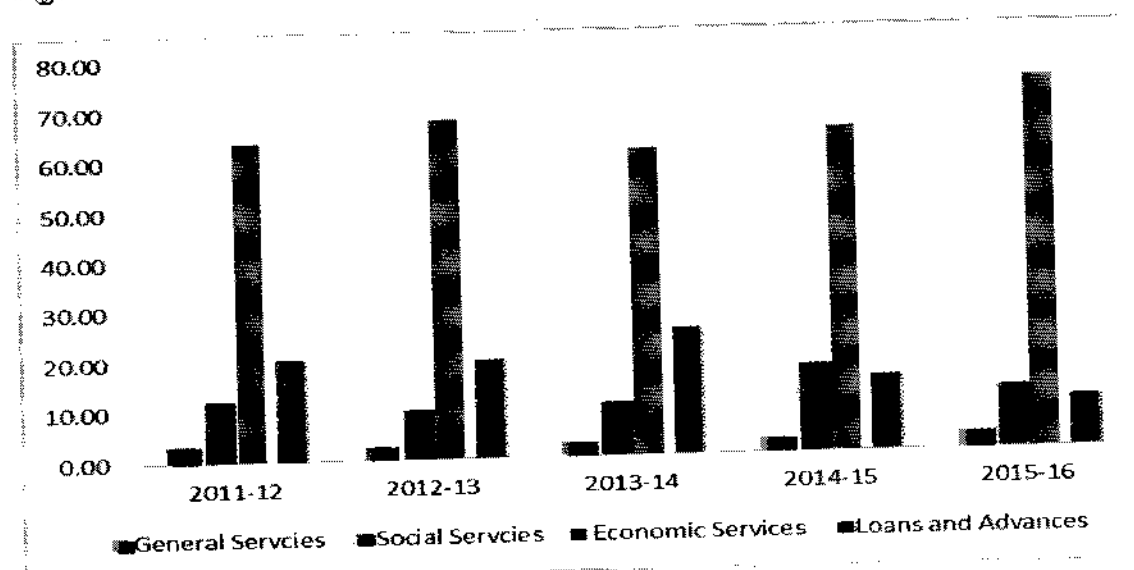
Source: Budget in Brief, GoK, various issues & Finance Accounts, C & AG, 2015-16.

Figure 3.3: Capital Expenditure GDP Ratio – 2011-12 to 2015-16



Source : Table 1.4

Figure 3.4: Share of Components in Capital Expenditure- 2011-12 to 2015-16



Source: Table 3.5

3.6.2 It is apparent that temporary fiscal space for higher capital spending was available in 2015-16, mainly because of a) higher Central tax devolution and RD grants for a three year period from the award of the 14th FC, b) delaying payment of pay revision arrears and c) lower devolution of funds to LSGs due to change in procedure of release of funds. In other words, the increase in Capital Expenditure in 2015-16, cannot be sustained unless the preponderance of Revenue Expenditure is moderated, which is difficult as already stated. Innovative measures to increase capital spending are a necessity in the short and medium run to boost the slowing economic growth in the state.

3.7 Public Expenditure Management: The Issue of Rush of Spending

3.7.1 One of the major issues in public expenditure management in Kerala is rush of spending towards the end of the financial year. The observations of the C& AG in this regard are relevant as it reflects on the poor expenditure management during a financial year. One of the major reasons for last minute rush in spending is passing the budget is done in July.

Till then the expenditure is managed by Vote - on - Account, which is only for the limited purpose of defraying routine expenditure. When the full budget is allotted and administrative and financial sanctions are obtained for incurring expenditure, much time would have elapsed. The procedures for spending are completed as late as December- January in a financial year. The consequences of this are discussed elaborately in Chapter 4 of this report.

3.7.2 The advancing of the budget to January, would enable the early starting of procedures for spending and it is hoped that it would go a long way in putting an end to the last minute rush for withdrawal of funds. The observations of the C & AG on last minute rush of spending is reproduced below (Kerala Finance Accounts 2015-16, Volume II, page 65)

“Rush of Expenditure: In terms of the Kerala Budget Manual, rush of expenditure in the closing month of the financial year should be avoided. During March 2016, however, the State Government incurred an expenditure of Rs.12097.39 crore (14.04 percent of the total expenditure of Rs.86189.51 crore under Revenue and Capital heads for the year). Details of the 9 major Heads of Account where the expenditure incurred in March 2016 ranged between 50 percent and 100 percent of the total expenditure are given at Annexure G.

Annexure G

(Referred to para 3 (ix) of Notes of Accounts on page 65)

Major Heads of Account where the expenditure incurred in March 2016 ranged between 50 percent and 100 percent of the total expenditure

(Rs.In crore)

Sl .No	Major Head	Expenditure during March 2016	Total expenditure during 2015-16	Percentage
1	5475-Capital Outlay on Other General Economic Services	875.61	879.22	99.59
2	5051-Capital Outlay on Ports and Light Houses	159.28	197.75	80.55
3	5425-Capital Outlay on Other Scientific and Environmental Research	0.53	0.75	70.67
4	2551-Hill Areas	72.81	109.03	66.78
5	4055-Capital Outlay on Police	2.38	3.66	65.03
6	4401-Capital Outlay on Crop Husbandry	10.87	19.12	56.85
7	3435-Ecology and Environment	11.19	21.27	52.61
8	4810-Capital Outlay on New and Renewable Energy	2.70	5.17	52.22
9	5056-Capital Outlay on Inland water Transport	1.60	3.10	51.61

Chapter 4

Public Debt Management

4.1 Public Debt: Structure and Trends

4.1.1 The high growth in the public debt (Table 4.1) of the State is an area of concern not only because its size is growing (especially when growth rate of nominal GSDP is slowing down) but also because a larger part of the debt is utilised for covering Revenue Deficit, leaving only limited resources for Capital Expenditure. The 13th FC award had outlined an adjustment path for bringing RD to zero, FD to 3 percent of GSDP and Debt to 29.8 percent of GSDP by 2014-15. Other than Debt/GSDP ratio no other targets suggested by 13th FC have been achieved, (Table 4.2). As regards Debt/GSDP ratio, slowing down of nominal GSDP growth has reduced the differential between interest rate and nominal GSDP growth rate and this calls into question the sustainability of Public Debt with persisting Primary Deficit (Table 1.3). The debt stock and its structure are given in Table 4. 3.

Table 4.1: Growth rate of Public Debt: 2011-12 to 2015-16 (% per annum)

Year	Debt Stock (Rs crore)	Growth rate of Public Debt	Growth Rate of Nominal GSDP
2011-12	89418	13.66	
2012-13	103561	15.82	13.25
2013-14	119009	14.92	12.79
2014-15	135440	13.81	10.22
2015-16	157370	16.19	8.59

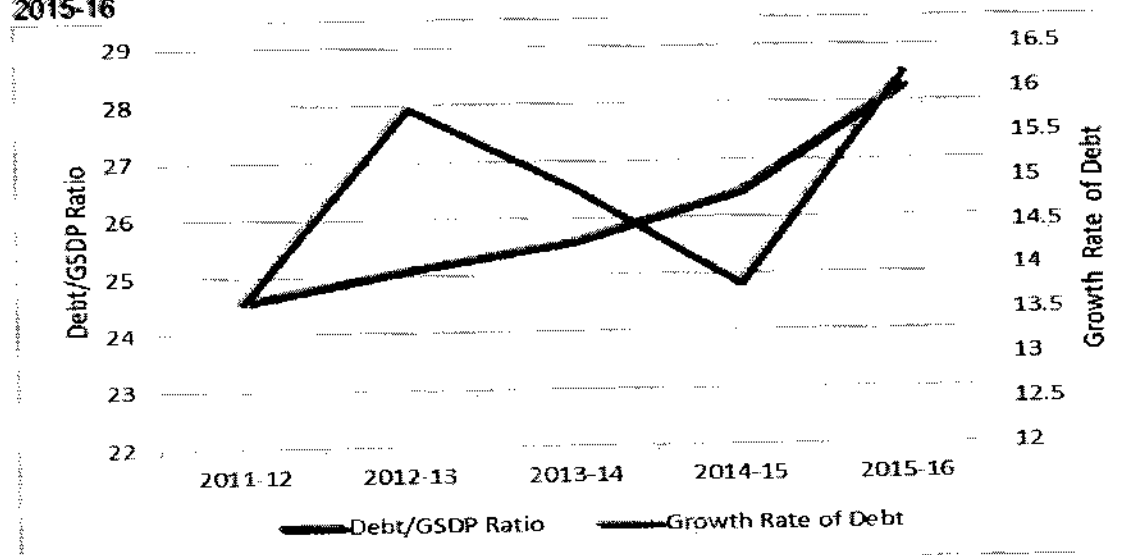
Source: Finance Accounts, C & AG, various issues

Table 4.2: Adjustment path set by 13th FC and Achievement (% of GSDP)

Item	2012-13		2013-14		2014-15		2015-16	
	Target	Actual	Target	Actual	Target	Actual	Target	Actual
Revenue Deficit/GSDP	0.9	2.27	0.5	2.43	0	2.69	0	1.73
Fiscal Deficit/GSDP	3.5	3.64	3.0	3.64	3.0	3.64	3.0	3.20
Debt/GSDP	32.3	25.12	31.7	25.59	30.7	26.42	29.8	28.27

Source: 13th FC Report and Table 1.4

Figure 4.1: Trend in Growth Rate of Public Debt and Public Debt-GSDP Ratio: 2011-12 to 2015-16



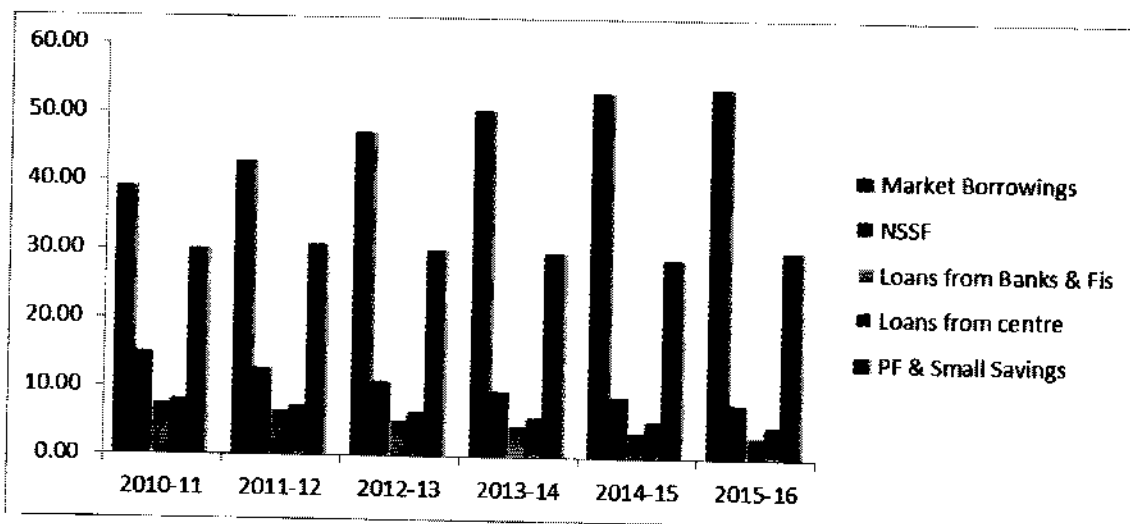
Source: Tables 1.4

Table 4.3: Debt Stock - Structure - 2010-11 to 2015-16

Sl. No	Item (Rs. Crore)	2011-12	2012-13	2013-14	2014-15	2015-16
1	Market Borrowings	38239	48810	60183	71960	84846
2	Special Securities issued to NSSF	11290	11323	11281	11806	12537
3	Loans from Banks and Financial Institutions	5867	5496	5340	5302	5113
4	Internal Debt (1)+(2)+(3)	55396	65629	76804	89068	102496
5	Loans from Centre (5)	6396	6622	6662	7065	7235
6	Provident Fund, Small Savings etc (6)	27625	31311	35543	39307	47639
6A	Treasury Deposits out of (6) 6A	11632	12870	14701	15900	21515
7	Total Debt * (4)+(5)+(6)	89418	103561	119009	135440	157370
Components (% per annum)						
	Market Borrowings	42.76	47.13	50.59	53.17	53.91
	NSSF	12.63	10.93	9.48	8.72	7.97
	Loans from Centre	6.56	5.31	4.49	3.92	3.25
	Provident Fund and Small Savings	7.15	6.39	5.57	5.22	4.6
	Treasury Deposits out of PF & Small Savings	42.11	41.1	41.36	40.55	45.16

Source: Finance Accounts C&AG various issues. Note *Total Debt excludes Reserve Funds, Deposits and Advances, Suspense and Miscellaneous and Remittances.

Figure 4.2 Components of Total Debt (%)



Source: Table 4.3

4.1.2 The changing structure of Total Debt during 2011-12 to 2015-16, reveals that the share of NSSF, a high cost component is showing a secular decline. The share of the comparatively low cost Market Borrowings has increased from 42.76 percent to 53.91 percent during 2011-12 to 2015-16. The share of Loans from Centre has also declined as Centre has discontinued with the practice of on lending to States after the 12th FC recommendations.

Table 4.4: Fiscal deficit and Borrowing (Rs. crore)

Item	2011-12	2012-13	2013-14	2014-15	2015-16
Fiscal Deficit (A)	12815	15002	16944	18642	17818
Borrowings net of repayments from Consolidated Fund (B)	7034	10711	11294	12635	13722
Net receipts under Public Account (C)*	4514	5191	3237	5378	5674
Borrowings and Liabilities (D) = (B+C)	11548	15902	14531	18013	19396
Variation (E) = (A)-(D)	1267	-900	2413	629	-1578

Source: Finance Accounts C & AG * Public Account includes net figures under Small savings & PF, Deposits and Advances, Suspense and Miscellaneous, Remittances and General cash balance.

4.1.3 Fiscal Deficit is the gap between total receipts including non-debt capital receipts and total expenditure from the Consolidated Fund of India or of the respective State, during a financial year. This is financed through net borrowings, net credit balance in the Public Account and available cash balances drawn down. Net credit under Public Account comprises includes current liabilities including amounts transferred from consolidated Fund of the State. Amounts unspent during the relevant financial year adds to the expenditure obligations over and above what is sanctioned for the future financial year by the legislature.

4.1.4 Unlike the balances in Consolidated and Contingency Funds (under Articles 266(1) and 267 of the Constitution), the Public Account (under Article 266(2) of the Constitution)

balances are held in fiduciary capacity by the government. But the liabilities of the Public Account do form part of the cash balances of the Central and the respective State governments.

4.1.5 The expenditure for a financial year can be incurred only through legislative sanction, by presenting Demands for Grants (and if necessity arises by presenting Supplementary Demands for Grants) and an Appropriation Bill for drawing the allotted sums from the Consolidated Fund of India or of the respective States. If the moneys cannot be appropriated during the financial year, it has to be surrendered as savings or it lapses at the end of the financial year.

4.1.6 To circumvent the surrendering of moneys, the practice of withdrawing the allotted amount and putting it in Treasury Savings Bank (TSB) Account of department / institution opened in the name of the authorised official is resorted to. Since the amount is transferred to the Public Account from the Consolidated Fund of the State, the same is treated as appropriated and spent, but in effect, the concerned institution or the department gets an extended time for spending than the one financial year period authorised by the Legislature. Table 4.5 gives details of deposits into the Special TSB accounts, by institutions during the period 2011-12 to 2015-16 and this is substantially reflective of this practice. The flip side of this practice is that Revenue Deficit or Capital Outlay, as the case may be, for a financial year gets artificially inflated, if the amount transferred to Public Account is not spent during the same financial year. Fiscal Deficit which is the aggregate of Revenue Deficit, Capital Outlay and Net Lending during a financial year, is also inflated to the that extent.

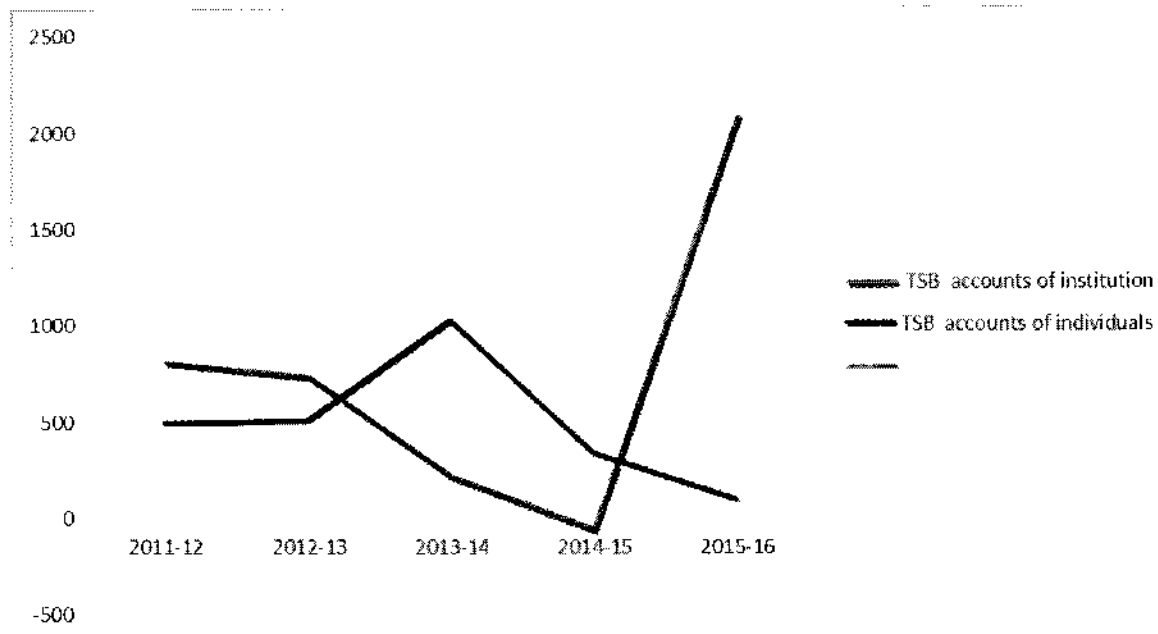
Table 4.5: Deposits in Public Account (Rs crore)

Head of Account	2011-12	2012-13	2013-14	2014-15	2015-16	Remarks
8031-00102-99-01	488	503	1018	334	91	Individuals
8031-00102-99-02	808	729	212	-61	2083	Institutions
8031-00102-98-01	-369	-310	-329	-156	544	Individuals
8031-00102-98-02	294	334	931	1082	2898	Institutions

Source: Finance Accounts, C & AG, various issues

4.1.7 The problem is complicated further when a withdrawal is made from Consolidated Fund and parked in Public Account, without the backing of cash. In other words, there would be allocation in the budget head, but no cash resources at that moment to fund the spending. In simple terms, the TSB account opened in Public Account is a notional one and is therefore unfunded. This results in part of the Borrowings and Liabilities having no fund backing. As already mentioned, when this gets carried over to the next financial year, it would place stress on that year's cash resources. If the cash crunch continues, the unfunded balances get carried over to more than one financial year, which makes the estimation of debt, deficit and liabilities less transparent.

Figure 4.3: Treasury Savings Bank Accounts by Institutions and individuals (Rs crore)



Source: Table 4.5

4.2 Targets outlined by 14th Finance Commission and Actual Performance

4.2.1 As mentioned earlier, with regard to FD and borrowings, the 14th FC has outlined the following:

- Fiscal deficit of all States will be anchored to an annual limit of 3 per cent of GSDP. The States will be eligible for flexibility of 0.25 per cent over and above this for any given year for which the borrowing limits are to be fixed if their debt-GSDP ratio is less than or equal to 25 per cent in the preceding year.
- States will be further eligible for an additional borrowing limit of 0.25 per cent of GSDP in a given year for which the borrowing limits are to be fixed if the interest payments are less than or equal to 10 per cent of the revenue receipts in the preceding year.
- The two options under these flexibility provisions can be availed of by a State either separately, if any of the above criteria is fulfilled, or simultaneously if both the above stated criteria are fulfilled. Thus, a State can have a maximum Fiscal Deficit-GSDP limit of 3.5 per cent in any given year.
- The flexibility in availing the additional limit under either of the two options or both will be available to a State only if there is no Revenue Deficit in the year in which borrowing limits are to be fixed and the immediately preceding year.

4.2.2 With respect of these conditionalities, where exactly the State stands may be seen from Table 4.6.

Table 4.6. Debt, Deficit and Interest Payment

Item (%)	2011-12	2012-13	2013-14	2014-15	2015-16
Revenue Deficit/GSDP	2.21	2.27	2.43	2.69	1.73
Fiscal Deficit/GSDP	3.52	3.64	3.64	3.64	3.20
Primary Deficit/GSDP	1.79	1.89	1.87	1.73	1.21
Debt / GSDP	24.56	25.12	25.59	26.42	28.27
Interest Payment/RR	16.56	16.32	16.81	16.86	16.10

Source: Table 1.4

4.2.3 In this context, it may be observed from Table 4.6 that the State would not be able to avail of the additional borrowing limit of 0.50%, as the basic condition of zero RD is not likely to be met even at the end of the 14th FC award period in 2019-20. From Table 4.6, it is also clear that the large scale borrowings since 2011-12 has caused higher annual growth rate of debt, though cushioned by a larger denominator effect due to change in methodology and base year of GSDP computation. The Interest Payments - RR ratio has also risen due to the increased interest payment on account of higher borrowings, reversed by the larger central transfers in 2015-16.

4.2.4 This Committee is of the view that the high level of deficit ratios would impede the ability of the State to go for market borrowings in the long run. It is also to be taken note of that under NSSF, the loans availed upto 2014-15 have got a period of 25 years for repayment, with the first five years being moratorium period. But from 2015-16 the tenure of the loan has been reduced to 10 years. This would result in repayment liabilities within a shorter span of time for NSSF borrowings after 2014-15. Yet another aspect is that though the Central loans on account of Externally Aided Projects (EAP) have a longer schedule of repayment, there is exchange rate fluctuation risk in these loans. Provident Fund and Small Savings are Public Account liabilities, the repayment claim on which is difficult to predict.

4.3 Deficit Indicators – Implications for Future

4.3.1 The targets as laid down in the KFRBM Act 2003 (as amended in 2011), for major deficit indicators of RD and FD could not be achieved. The RD has exceeded the target consistently ever since the KFRBM Act was amended in 2011. The relative reduction in RD achieved in 2015 -16 (Table 4.6) is not likely to sustain itself as it has been achieved due to compression and delay in implementation of pay revision, while the lower growth in Own Tax revenues have continued.

4.3.2 Another pertinent issue is the suggestion to have a debt anchoring target by amending Fiscal Responsibility Acts, as recommended by the Review Committee. Though not in accordance with the targets indicated by the 14th Finance Commission, there is a possibility of the benchmarks set by the Committee becoming targets in future. In Chapter 5, of this report, the salient recommendations of the Committee have been discussed. The glided path suggested by the Committee stipulates FD/GSDP ratio at 2.5 percent for the Centre and 1.8 percent for the States by 2022-23. The Debt-GSDP ratio is suggested at 60 percent, 40 percent for the Centre and 20 percent for the States. If this were to be implemented, then it would seriously constrain the fiscal space of the States, especially in the face of substantial share of committed expenditure, uncertainties resulting from implementation of GST and

additional expenditure commitments due to restructuring of Central grants. The compression of debt and deficit targets recommended would considerably impede the capital expenditure of the States as substantial part of the revenue expenditure is not downwardly flexible.

4.3.3 Observations by C & AG on Guarantees, Consolidated Sinking Fund and Guarantee Redemption Fund

4.3.4 While discussing future implications, this Committee is of the view that the observations by C & AG in Kerala Finance Accounts 2015-16, Volume II (Pages 60, 62 and 63), regarding non-provisioning of certain funds are very relevant and hence reproduced below:

Guarantees: Guarantees reported in Statements 9 and 20 are based on information received from the State Government which is the authority for issuing such guarantees. The total outstanding Government Guarantee as on 31 March 2016 is Rs. 12438.52 crore which was within the limit of Rs. 21,000 crore prescribed under the Kerala Ceiling on Government Guarantees Act, 2003 read with the Kerala Ceiling on Government Guarantees Act (Amendment) Act, 2015. The Act stipulated that a minimum of 0.75 percent of Government guarantee be deposited each year as Guarantee Commission, which could not be waived under any circumstances. Guarantee Commission of Rs. 88.83 crore was received during 2015-16. Out of which Rs 0.17 crore could not be shown against the respective institutions in Statement 9 and 20 due to non receipt of details from State Government. From the date of commencement of the Act, till 31 March 2016, Rs. 96.96 crore was outstanding from various entities towards Guarantee Commission. (C&AG Finance Accounts 2015-16 Vol I Page No 60)

Consolidated Sinking Fund (CSF): In terms of the recommendations of the Twelfth Finance Commission, all States should set up sinking funds for amortisation of all loans including loans from banks, liabilities on account of National Small Savings Fund (NSSF) etc. The Fund should be maintained outside the Consolidated Fund of the State and should not be used for any other purpose, except for redemption of loans. The guidelines of the Reserve Bank of India (RBI), which is responsible for administration of the Fund stipulate a minimum annual contribution of 0.5 percent of the outstanding liabilities at the beginning of the year to the Fund

Accordingly the State Government set up a CSF for redemption of outstanding liabilities. The corpus of CSF, at the beginning of the year 2015-16 being Rs. 1610.37 crore constitutes 1.13 percent of the outstanding liabilities (Rs. 141946.89 crore) as on 01 April 2015. The State Government, however, against a requirement of Rs. 709.73 crore (0.5 percent of the outstanding liabilities of Rs. 141946.89 crore as on 01 April 2015), did not contribute any amount to the Fund during the year. Non-contribution to CSF has resulted in understatement of revenue expenditure to the extent of Rs. 709.73 crore. (C&AG Finance Accounts 2015-16 Vol I Page No 62)

Guarantee Redemption Fund: As per the recommendations of the Twelfth Finance Commission, State Governments are required to constitute a Guarantee Redemption Fund to be utilized for meeting the payment of obligations arising out of the guarantees issued by the Reserve Bank of India. Under the guidelines, the State Government is required to make minimum annual contribution of 0.5 percent of outstanding guarantee at the beginning of year. The proceeds of the Fund are invested in Government of India securities and this does not form a part of the State Government Cash balance.

In terms of the Kerala Ceiling on Government Guarantees Act, 2003 the guarantee commission received annually are to be transferred to the Public Account and these contributions shall form the corpus of the Guarantee Redemption Fund (GRF) under Public Account of the State. As the State government has not constituted GRF as per para 6 of the Kerala Ceiling on Government Guarantees Act, 2003 and RBI guidelines, guarantee commission of Rs.88.83 crore collected during 2015-16, was not transferred to the Fund under Public Account, leading to understatement of revenue expenditure to this extent (C&AG Finance Accounts 2015-16 Vol I Page No 63).

4.3.5 Had provision been made for these funds in 2015-16, the Revenue Expenditure would have increased to Rs.79488 crore from Rs.78689 crore in 2015-16

Chapter 5

FRBM Review Committee Report: Implications

5.1 The Committee to review the Fiscal Responsibility and Budget Management (FRBM) Act, has submitted its report to the Government of India in 2017. The main recommendations of the Committee are:

1. *The present FRBM Act should be repealed and a new Debt and Fiscal Responsibility Act should be enacted and an independent Fiscal Council should be formed.*
2. *The Debt-GDP ratio should be anchored to 60 percent. Out of this, Centre and States are to have 40 and 20 percent respectively.*
3. *The Fiscal Deficit of the Centre and the States should be reduced in a glided path and brought to 2.5 and 1.7 percent of GDP respectively and Revenue Deficit GDP ratio should be brought down to 0.8 percent of GDP for the Centre. Though Debt - GDP ratio of States is close to the anchor of 20 percent (at 21 percent), the primary balances of the States are in a much worse shape than that of the Centre. Hence a lower Fiscal Deficit-GDP ratio has been suggested for the States. The targets are to be achieved in a phased manner by financial year 2022-23.*
4. *The deviations from the target should not exceed 0.5 percent in a financial year*
5. *The targets can exceed only under exceptional circumstances and fall in output growth of 3 percentage points over the average of three preceding quarters. Similarly, Fiscal Deficit- GDP ratio should fall by 0.5 percent if the output growth increases by 3 percentage points than the average of three preceding quarters.*

5.2 An Analysis of the Recommendations of FRBM Review Committee, 2017

5.2.1 It can be seen that the Committee has shifted its focus to Debt - GDP ratio from Fiscal Deficit - GDP ratio. The latter is targeted to come down so that total debt GDP ratio is anchored at 60 percent from the present 69 percent (as on March 31st 2016). The logic stated by the Committee to target fiscal deficit of the Centre and the States at 5 percent of the GDP is similar to what is stated in the present FRBM framework in which ratio of 3 percent each are fixed for the Centre and the States. To state in brief, it is as follows:

5.2.2 The ratio of domestic savings to GDP is 7.6 percent and that of external borrowings is at 2.3 percent, which takes the total to 10 percent approximately. Dividing this equally between the government and private sector, 5 percent each is apportioned. The 5 percent apportioned for the government sector is divided as 2.5 percent between the Centre and the States.

5.2.3 But the committee set a lower target for the States at 1.7 percent of GDP as against 2.5 percent of GDP for the Centre, citing relatively larger primary imbalances of the States vis-a-vis the Centre. There is a note of dissent by one of the members of the Committee. In that, the political feasibility of the sharp cut in fiscal deficit in 2017-18 as part of the glide down is questioned. The note also challenges the ratio arrived at by the Committee, but it also suggests a sharp reduction through balancing the primary deficit. The rejoinder by the Committee is also part of the report.

5.2.4 The Committee cites a 2008 study by Reinhart and Rogoff (National Bureau of Economic Research (NBER) Working Paper No 13882, March) to emphasise the point that the output costs of domestic defaults can be very high and in fact can be worse than that of external debt.

5.2.5 In a later study (also cited by the Committee), titled "Growth in a Time of Debt", authored by Reinhart and Rogoff (NBER Working Paper No.15639, January 2010), the findings are as follows:

"We study economic growth and inflation at different levels of government and external debt. Our analysis is based on new data on forty-four countries spanning about two hundred years. The dataset incorporates over 3,700 annual observations covering a wide range of political systems, institutions, exchange rate arrangements, and historic circumstances. Our main findings are: First, the relationship between government debt and real GDP growth is weak for debt/GDP ratios below a threshold of 90 percent of GDP. Above 90 percent, median growth rates fall by one percent, and average growth falls considerably more. We find that the threshold for public debt is similar in advanced and emerging economies. Second, emerging markets face lower thresholds for external debt (public and private)—which is usually denominated in a foreign currency. When external debt reaches 60 percent of GDP, annual growth declines by about two percent; for higher levels, growth rates are roughly cut in half. Third, there is no apparent contemporaneous link between inflation and public debt levels for the advanced countries as a group (some countries, such as the United States, have experienced higher inflation when Debt/GDP is high). The story is entirely different for emerging markets, where inflation rises sharply as debt increases." (Abstract)

5.2.6 In another study by M. Reinhart, R. Reinhart and Rogoff 'Public debt Overhangs: Advanced economy episodes since 1800' *Journal of Economic Perspectives*, Volume 26, Number 3, summer, 2012 (Pp 69-86), though the conclusion of lower economic growth in a prolonged high debt period is reiterated, the following important observations are also made:

"...There is little to suggest a systematic mapping between the largest increases in average interest rates and the largest (negative) differences in growth during the individual debt overhang episodes....."

"Is the public debt overhang causing the slower growth? Or is an exogenous shock that causes slower growth either helping to generate the public debt overhang or else prolonging the escape from that debt overhang? This endogeneity conundrum has not been fully resolved. However, a number of recent studies have tackled the problem. The common finding from a number of approaches is that the relationship between public debt and growth is nonlinear, but at high levels, often at a debt/GDP ratio around 90 percent of GDP, public debt overhang does seem to have a negative effect" (Page No 80)

5.2.7 Though the authors are not drawing a conclusion either a) about public debt overhang choking economic growth through rising interest rates or b) about public debt overhang causing slower growth or slower growth being cause of public debt overhang, they reiterate the finding that at around 90 percent of GDP, public debt slows down economic growth.

5.2.8 It also needs a mention that the reiterated finding that economic growth slows down at 90 percent debt GDP ratio has been empirically challenged by Hendron, Ash and Pollin in their study titled "Does High Public debt consistently stifle Economic Growth? A critique of Reinhart and Rogoff.", *Political Economy Research Institute (PERI)*, University of Massachusetts, Amherst, April 2013.

5.2.9 The 2010 study of Reinhart and Rogoff finds the threshold limit at 90 percent for advanced and emerging economies for debt not to adversely affect economic growth. But it also stated that for emerging markets, the threshold can be lower at 60 percent, if the debt is usually denominated in foreign currency. As already pointed out, the basis of these thresholds has been challenged in other academic studies. But in the case of India, share of

public debt is predominantly domestic, and External Debt as a proportion of total Central Government liabilities is 6.2 percent during 2015-16 (Table 5.1). Hence the threshold of 60 percent debt- GDP ratio, suggested by Reinhart and Rogoff (2012) would not be applicable.

Table 5.1: Structure of India's Public Debt- All India: 2013-14 to 2015-16

Item	2013-14	2014-15	2015-16
External Debt as a proportion of Central Government Liabilities (%)	7.00	6.2	6.2
Weighted Average Maturity of Government of India Securities issued during the financial year (in Years)	14.22	14.66	16.03
Average Interest Cost (AIC) to the Centre	6.7	6.6	6.6
Nominal GDP growth minus AIC	6.6	4.2	2.2
Central Government Debt as a proportion of GDP (%)	47.4	47.0	48.0
General Government (Centre + States) Debt as a proportion of GDP (%)	66.8	67.1	68.6

Source: Table in Executive Summary, Status Paper on Government Debt, September 2016, dea.gov.in

5.2.10 Other favourable features that can be noticed from the debt sustainability point of view in the Indian context are a) longer period of maturity of Government securities and b) positive (though declining) gap between AIC and nominal GDP growth (Table 5.1).

5.2.11 A stringent Debt-GDP target and with permission for relaxation only when output growth falls by 3 percent points over the average of previous three quarters, can hamstring the fiscal policy discretions and can make the national governments depend more and more on monetary policy in the case of growth slowdowns. In this context, the findings of the study by Stiglitz (2016) in NBER Working Paper No. 22837, titled, 'The Theory of Credit and Macro Economic Stability', is quite pertinent. The brief of the same are reproduced below:

"In the aftermath of the Great Recession, there is a growing consensus, even among central bank officials, concerning the limitations of monetary policy. This paper provides an explanation for the ineffectiveness of monetary policy, and in doing so provides a new framework for thinking about monetary policy and macro-economic activity. What matters is not so much the money supply or the T-bill interest rate, but the availability of credit, and the terms at which credit is made available. The latter variables may not move in tandem with the former. In particular, the spread between the T-bill rate and the lending rate may increase, so even as the T bill rate decreases, the lending rate increases. An increase in credit availability may not lead to more spending on produced goods, but increased prices for land or other fixed assets; it can go to increased margins associated with increases in speculative activity; or it may go to spending abroad rather than at home. The paper explains the inadequacy of theories based on the zero low bound, and argues that the ineffectiveness of monetary policy is more related to the multiple alternative uses—beyond the purchase of

domestically produced goods—of additional liquidity and to its adverse distributional consequences. The paper shows that while monetary policy is less effective than has been widely presumed, it is also more distortionary, identifying several distinct distortions.” (Abstract)

5.2.12 These limitations clearly point to the need for a countercyclical fiscal policy. In a paper titled “Fiscal Policy in a Depressed Economy” Delong and Summers (*Brookings Papers on Economic Activity* Spring, 2012), have stated that expansionary fiscal policy in a downturn can be effective and it would be self-financing. The brief of the finding is extracted below:

“In a depressed economy, with short-term nominal interest rates at their zero lower bound, ample cyclical unemployment, and excess capacity, increased government purchases would be neither offset by the monetary authority raising interest rates nor neutralized by supply-side bottlenecks. Then even a small amount of hysteresis—even a small shadow cast on future potential output by the cyclical downturn—means, by simple arithmetic, that expansionary fiscal policy is likely to be self-financing. Even if it is not, it is highly likely to pass the sensible benefit-cost test of raising the present value of future potential output. Thus, at the zero bound, where the central bank cannot or will not but in any event does not perform its full role in stabilization policy, fiscal policy has the stabilization policy mission that others have convincingly argued it lacks in normal times. Whereas many economists have assumed that the path of potential output is invariant to even a deep and prolonged downturn, the available evidence raises a strong fear that hysteresis is indeed a factor. Although nothing in our analysis calls into question the importance of sustainable fiscal policies, it strongly suggests the need for caution regarding the pace of fiscal consolidation.”(Abstract)

5.2.13 Based on the above facts and circumstances, it is felt that the stringent conditions suggested by the FRBM Review Committee that a fall in output growth rate of 3 percentage points below the average of the preceding three quarters is necessary to relax the Fiscal Deficit- GDP ratio, in effect neutralises the intervention potential of the fiscal policy even in a situation where downturn of economic growth deepens in substantial measure.

5.2.14 In the Indian context, a study by Kaur et al (2014), RBI Working Paper Series No. 7, titled ‘Debt Sustainability at States level in India’, has found that the debt is sustainable and has observed as under:

“The debt position of the state governments in India, which deteriorated sharply between 1997-98 and 2003-04, has witnessed significant improvement since 2004-05, reflecting the impact of both favourable macroeconomic conditions and policy efforts by the Central and state governments. The debt sustainability analysis carried out in the paper, based on empirical estimation of inter-temporal budget constraint and fiscal policy response function in a panel data framework, covering 20 Indian states for the period 1980-81 to 2012-13, indicates that the debt position at the state level is sustainable in the long run. Disaggregated level analysis, however, reveals that despite an overall improvement in debt position of the Indian states, some of the states continue to show signs of fiscal stress and increasing debt burden. The recent slowdown in growth momentum, which is likely to affect the revenue raising capacity of the state governments, may lead to further deterioration in debt position of these states. Contingent liabilities, primarily in the form of issuance of

guarantees by the state governments, remain another area of concern. The strong presence of contingent liabilities calls for a holistic assessment of debt position of states by reckoning their off-budget fiscal position including the impact of operations of state public sector enterprises.” (Abstract)

5.2.15 The overall findings appear to veer around the conclusion that public debt in India is at present sustainable, but certain specific corrections are necessary. In view of this, the sharp reduction of Fiscal Deficit – GDP ratios suggested by the FRBM Review Committee for anchoring total debt-GDP ratio to 60 percent would in all probability impede the development and capital spending, especially of State governments and can in the medium run adversely impact economic growth.

5.2.16 Other pertinent points to be examined in the Indian context are:

1. *The basis for fixing ratio of 2.5 percent FD- GDP ratio*

The Committee has followed the earlier methodology which fixed 3 percent each for the Centre and the States. Total savings available for borrowing is taken at 10 percent and the space is equally apportioned for government and private sector (as against earlier 60:40 ratio). It should be noted that though the 5 percent space is to be divided equally between the Centre and the States, the glided path of Fiscal Deficit - GDP is fixed at 1.7 percent for States, as they have more imbalanced primary accounts. These targets are to be achieved by 2022-23 as the debt GDP ratio is to be anchored to 60 percent. Since Centre's FD GDP ratio is targeted at 2.5 percent and for all States at 1.7 percent, 0.8 percent of the 5 percent space would be left unutilised by the government sector.

In fixing this ratio, what has not been taken into account is that there are circumstances when business confidence is low, the private sector may not utilise the 5 percent space left for them. This is precisely the present scenario. In such a case, the government sector borrowing and spending would have crowding in impact. This would cause the growth to rise and per capita incomes to increase. Depending on Marginal Propensity to Consume among various income groups, the ratio of savings would not remain a static pool over the years as it is now and can expand. This can enable recalibrating FD targets and it need not glide down sharply, even if the debt rule target is fixed. The exceptional circumstance of economic growth rate falling to 3 percent from the average of preceding three quarters is too stiff a target and effectively prevents counter cyclical fiscal policy when there is slowdown of economic growth.

2. *Impact on State Finances*

The Report is appreciative of the fiscal consolidation achieved at the all States level in the post FRBM period and has noted that deficit targets have been achieved by rich and poor States without difference. The points not taken into consideration are:

- a) The buoyant growth of VAT revenues during the period till 2013-14 has considerably slowed down and has reached a low point of no growth during 2015-16 for certain States. The uncertainties associated with implementation of GST will affect buoyancy of Own Tax Revenues of States at least in the short run.

- b) The expenditure commitments of the States due to implementation of Pay Commission recommendations in the face of stagnant Own Tax Revenues would work against fiscal consolidation.
- c) Though there has been higher tax devolution at 42 percent consequent to the 14th Finance Commission recommendations, there has been restructuring of grants and the effective fiscal space of the States have not expanded as expected, though flexible devolution has risen in comparison to the tied grants.

In view of these, an alternative perspective would be to suggest that the debt GDP anchor at 60 percent needs a gliding down, instead of the deficit targets. This would give more borrowing space in the medium term. The Committee elaborates the question of credibility before international credit rating agencies. As pointed out in the note of dissent, the credibility of India is quite high, as it has not defaulted on debt, even during the 1991 foreign exchange crisis period.

5.3 Implications of the Recommendations of the FRBM Review Committee for Kerala

5.3.1 With specific reference to Kerala, it must be noted that the FRBM Review Committee's recommendations would require a massive correction in both FD and outstanding debt. The adjustment path should aim at curtailing FD to GSDP ratio and Debt to GSDP ratio from 3.20 percent and 28.70 percent in 2015-16 to 1.70 percent and 20 percent respectively by the year 2020. The adjustment path required to meet the new targets as recommended by the Committee would however have significant bearing on the State finances.

5.3.2 First, the adjustment path suggests that the correction required would place a relatively higher burden on Kerala vis-à-vis other States in the country given the fact that current FD and RD ratios for Kerala are already high. Secondly, to achieve the 20 percent Debt to GSDP target, the correction in FD from 3.20 percent to 1.7 percent by 2022-23, would place more burden on Kerala than the existing FRBM framework that would have required curtailing of FD to only 3 percent of GSDP.

5.3.3 If the Government of India accepts these recommendations and States are to follow, Kerala would have to drastically cut down overall expenditure or revenues have to become substantially more buoyant. The Government also needs to be cautious in ensuring that the burden of this fiscal correction does not fall disproportionately on Capital Expenditure. This report has already pointed out that sustaining the increase in capital expenditure seen in 2015-16 will be a challenge for the State Government given that the increase was brought about by certain favourable circumstances, the effects of which will eventually taper off. If the new targets have to be achieved in a timely manner, the onus will be on the State to exercise prudential financial management in a manner that does not curtail Kerala's Capital Expenditure any further (as it is one of the lowest in the country) in the wake of pressing demand to meet the ever growing committed revenue expenditure.

5.4 Alternative Suggestion: For a Pro active Fiscal Policy

5.4.1 The basis for debt anchoring rule at 60 percent of GDP suggested by the Committee is that our debt sustainability is based on the differential between nominal GDP growth rate and interest rate. According to the Committee, if this narrows down, debt sustainability would become questionable and thus entire reliance cannot be placed on this differential in future. Instead, consolidation of primary balances and debt should be aimed at. There cannot be a dispute on this issue in the long run. But whether fiscal policy can invigorate growth without a consistent rise of interest, especially in times of economic slowdown is the pertinent question to be answered. In such a scenario, growth will rise and its differential with interest rates

would be maintained and debt would not become unsustainable. The present economic condition in India is more akin to this.

5.4.2 It is felt that instead of a sharp cut in FD GDP ratio, the debt GSDP ratio should be subject to periodic review and put on cautious glided path, if the economic situation warrants the same. The States would be forced to substantially cut back Capital Expenditure, if FD-GDP ratio of 1.7 percent is targeted for 2022-23, as committed Revenue Expenditure cannot be curtailed. This would undoubtedly have an adverse impact on the economy, which is already showing signs of slowdown.

5.4.3 It is hoped that the 15th Finance Commission would take the State specific fiscal scenario into account and envision a fiscal consolidation path taking into consideration the prevailing situation and peculiarities instead of adopting the sharp gliding down of deficit targets.

Chapter 6

Summary and Conclusions

6.1. The Public Expenditure Review Committees are formed under section 6 of the Kerala Fiscal Responsibility Act of 2003 (Act 29 of 2003). As mandated in the Act, "The report should contain revenue receipts, resources from the Central Government, revenue expenditure, devolution to local self-Governments, administrative expenditure, deficits (revenue, fiscal, primary), capital receipts and expenditure and various categories of debt". This report reviews fiscal performance of the Government of Kerala for the year 2015-16, based on the parameters specified in the Act.

6.2 The review shows that there has been a reduction in fiscal imbalances in the year 2015-16. The growth rate of revenue expenditure has declined to 9.58 percent during 2015-16 as against an average of 20.18 percent during 2011-12 to 2014-15. This is the consequence of an absolute decline in Grants-in Aid to LSGs, substantial under spending under 44 major heads of account as pointed out by the C & AG and postponement of committed expenditure resulting from the award of the 10th State Pay Commission.

6.3 Own tax revenue growth also remained subdued during 2015-16. Fiscal year 2015-16 was the first year of the 14th Finance Commission award. Enhanced tax share and RD grants as per the award of the 14th Finance Commission have helped increase the overall revenue receipts during 2015-16. The Medium Term Fiscal Policy (MTFP) targets for receipts, expenditure and deficits and corresponding actuals are given in Table 6.1. As evident from the Table, there have been wide variations between the two. As per the MTFP, the state should have achieved revenue surplus of 0.1 per cent of GSDP in 2015-16. But the actual revenue account deficit was 1.73 percent of GSDP. Instead of 3 percent target of fiscal deficit, actual fiscal deficit was 3.2 percent of GSDP and debt was 28.27 per cent of GSDP instead of 26.32 per cent. Wide variations in revenue and expenditure forecasts are evident from Table 6.1. The FRBM Review Committee, appointed by the Government of India has suggested a glided path of reduction of all state FD to 1.7 percent of GDP by 2022-23. The Committee also recommended a reduction in all states Debt-GDP ratio to 20 percent from the present level of around 22 percent of GDP.

6.4 Since Kerala's debt-GSDP ratio is 28 percent and fiscal deficit is more than 3 per cent of GSDP, if the FRBM Review Committee report is accepted and its compliance by states became mandatory, this would imply a larger correction for the state of Kerala. Chapter 5 of

this report discusses the implications of the recommendations of the FRBM Review Committee on State finances with special reference to Kerala. This Committee is of the view that further reduction in the fiscal deficit target would have serious implications for capital expenditure at the state level.

Table 6.1 MTFP Targets and Actuals- 2015-16

Item	MTFP Targets	Actuals	Variation (%)
RD/GSDP	-0.01	1.73	+1.74
FD/GSDP	3	3.20	+0.20
DEBT/GSDP	26.32	28.27	+ 1.95
Other Projections			
SOTR	55830	38995	-30.15
Central Resources	18998	21612	+13.76
Revenue Expenditure	81294	78689	-3.20
Non Salary, Interest and Pension Expenditure	30380	31066	+2.26
Devolution to LSGs	9259	5029	-45.68

Source: MTFP Statement 2013-14, Finance Accounts, C& AG, 2015-16.

6.5 Chapters 2 and 3 of this report have undertaken a detailed analysis of revenue receipts and expenditure. The analysis undertaken in Chapter 2 shows that growth of revenue receipts has been 19.13 percent for 2015-16 as against 17.84 percent for 2014-15. In the year 2015-16, growth of Central transfer has been 40.03 percent. Despite exceptionally high growth in central transfers, moderate growth in overall revenue receipts can be attributed to the low growth rate of own tax revenue receipts. The Non-Tax Revenues growth in the year 2015-16 has been 15.66 percent. This was substantially lower than the growth rate of 30.65 percent in 2014-15.

6.6 This Committee is of the view that in the post-GST scenario, as regards the Own Revenue, the State should explore a) methods to periodically revise guideline values of land which should be the base for Stamp Duty and Registration Fees, b) Land Tax should be revised as the present rates are nominal. As part of effective monitoring, land records should be computerised on a priority basis and c) State can take initiative by requesting the Centre to raise the Constitutionally fixed ceiling of Rs.2500/- for Profession Tax to Rs.5000/- per annum, so that LSGs' Own Revenue sources would be augmented.

6.7 Another noteworthy aspect is the change in revenue structure of the state. There has been an increase in the share of untied component of transfer in aggregate transfers due to the increase in the share of tax devolution to 42 per cent of the divisible pool of Union taxes. However, restructuring of non- Finance Commission grants by the Union government has reduced the untied fiscal space as states had to make larger contribution for these schemes. Our analysis shows that increase in the untied part of the transfer is substantially higher as

compared to the reduction in the tied component of the grant. Though this is correct, the point remains that states are contributing more to the Centrally Sponsored Schemes compared to pre-14th Finance Commission award.

6.8 As regards the structure of revenue expenditure, which has been examined in detail in Chapter 3, it is seen that the growth rates of General Services and Economic Services declined and that of the Social Services increased during 2015-16 when compared to 2014-15. The growth rates of General, Economic and Social services for 2015-16 were 14.8, 8.84 and 16.36 percent respectively as against 18.14, 28.6 and 13.06 percent respectively for 2014-15. An analysis of shares of committed expenditure in revenue expenditure reveals that while the proportion of salaries stagnated at 30.19 percent during 2015-16 when compared to 30.14 percent for 2014-15, the same for interest and pensions increased to 14.12 and 16.60 percent from 13.62 and 15.68 percent respectively.

6.9 The results of our analysis and the prognosis for immediate future attempted in Chapters 2 and 3, dealing with trends in Revenue Receipts and Revenue Expenditure, leaves us with the relevant question as to what could Kerala probably do to move towards fiscal consolidation? With GST Council deciding tax rates, individual states cannot change taxes on commodities to mobilise additional revenue. Major expenditure cuts in the time when signs of economic slowdown are palpable may neither be fiscally desirable nor politically feasible. But, measures for expenditure streamlining are definitely possible by rooting out practices like last minute rush in spending and using Public Account deposits as an alternate route to show allotted sums as spent without actually incurring expenditure (discussed in detail in Chapter 4 of this report). Serious efforts should be taken to project a realistic budget estimate of revenues so that spending during a financial year can be synchronised with the inflows into the Consolidated Fund of the State.

6.10 Chapter 4 of this report discusses the debt profile of the State. Medium term sustainability of debt continues to be a concern due to the slowdown in growth rate of nominal GSDP during 2015-16 and the resultant narrowing down of the differential between nominal interest rate and nominal GSDP, which is known as Domar Gap in economic literature. If this persists and the differential ratio between nominal interest rate and nominal growth rate of GSDP narrows down further, State will not be able to fall back on a positive Domar Gap to keep the debt sustainable. Yet another aspect emerging from the analysis of the debt profile of the State is that annual growth rate of public debt has been higher than that of nominal GSDP during 2012-13 to 2015-16. In 2015-16, growth rates of public debt and nominal GSDP have been 16.19 percent and 8.59 percent respectively.

6.11 On the positive side, it is to be mentioned that high cost component of public debt, that is, NSSF, has been declining continuously and during 2015-16, its share in public debt was 7.97 percent as against 12.63 percent during 2011-12. The share of the relatively low cost market borrowings has gone up from 42.76 percent in 2011-12 to 53.91 percent during 2015-16.

6.12 In conclusion, this Committee emphasises that a well thought out expenditure management practice, making revenue targets in budgets realistic, aligning expenditure with achievable revenues are three necessary ingredients for a consolidation of State finances of

Kerala. Tapping potential of taxes not subsumed in GST also needs attention, but that may not be sufficient to correct the imbalances in the revenue account. Rationalisation of expenditure, particularly in revenue account, has to be done progressively and needs delicate balancing of priorities to bring the state on a sustainable fiscal path.

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