Finances of Karnataka: Fiscal Implications of Salary Hike

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Preface

This Study has been undertaken by the National Institute of Public Finance and Policy at the instance of the Karnataka Fifth State Pay Commission.

The Study Team consists of Pinaki Chakraborty and M. Govinda Rao. The opinions and analyses here are those of the authors. The members of the Governing Body of the National Institute of Public Finance and Policy are in no way responsible for these.

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Table of Contents

List of Tables

List of Figures

Finances of Karnataka: Fiscal Implications of Salary Hike

I. Introduction

Karnataka is a middle income State and one of the relatively better fiscally managed States in the country. The per-capita State Domestic Product (SDP) in Karnataka at Rs. 20,703 is 1.22 times higher than the all-State average[1]. Although in the 1990s, in keeping with the general trend, the State's fiscal situation deteriorated as reflected in its rising revenue and fiscal deficits during the 1990s, the period since 2001-02 has seen a turnaround. While in 2001-02, Karnataka had a revenue deficit of Rs. 3296.33 crore, the revised estimates for 2005-06, shows a surplus of Rs. 1187 crores and for 2006-07, the surplus is budgeted at Rs. 1534 crore. Similarly, fiscal deficit improved from Rs. 5881.77 crores in 2001-02 to Rs. 4764.09 cores in 2005-06 (RE) and is budgeted at Rs. 5210.56 cores. This, by all accounts is a significant improvement and in fact, way beyond that is envisaged under the fiscal restructuring plan by the Twelfth Finance Commission (TFC). The TFC had envisaged that the State would phase out its revenue deficit by the end of 2009-10. Nevertheless, the consolidated public sector deficit of the State still remains a matter of concern, particularly the large power sector subsidy and deficits thereon. The estimated budgetary subsidy to power sector in the year 2005-06 at Rs. 1750 crore constituted 1.05 per cent of GSDP.

The marked improvement in the fiscal situation was possible due to the proactive measures undertaken by the State towards fiscal correction. In the face of deteriorating fiscal position during the 1990s, the State took a significant step towards fiscal reforms by bringing out a White Paper on State Finances in March 2000 wherein issues relating to poor growth in tax receipts, mounting expenditure and debt stock were highlighted. In this context, the State has recognized that a year-on-year approach would be grossly insufficient to address the problem of fiscal imbalance, which were more structural in nature and a Medium term perspective was essential to correct the structural problems (Finance Department, 2005, p 4). Karnataka was the first State to introduce the Karnataka Fiscal Responsibility Act (KFRA) in

[1] The per capita income is an average of three years, i.e., from 1999-00 to 2002-03 based on the comparable GSDP estimate provided by the twelfth Finance Commission Report.

the FY 2002-03. The KFRA mandated the elimination of revenue deficit by 2005-06 and limiting of fiscal deficit to 3 per cent of GSDP by 2005-06. The KFR Act mandated the State Government to place Medium Term Fiscal Plan (MTFP), which shall set forth the fiscal policy of the State Government in the medium term (Finance Department, 2005, p 4). The State undertook a significant fiscal restructuring programme under the World Bank sponsored Structural Adjustment Lending (SAL) to the States. The SAL based fiscal consolidation started in the State since 2000. The MTFP of 2005-09 laid out a path of fiscal correction for the period until 2009 and has succeeded in its efforts so far in traversing in the path of fiscal consolidation (Finance Department, 2005).

Although there has been a significant improvement in the fiscal situation in the State, the important question is whether the improvement is structural, or is it merely due to some immediate transitory measures taken. In other words, will the improving trend in the fiscal situation continue and can the State withstand shocks like sudden expenditure spurt or an unexpected revenue shortfall. It must be noted that even in the early and mid 1990s, there was a perceptible improvement in the fiscal health of the State until the impact of the pay revision which, sharply increased revenue and fiscal deficits. The improvements in the early 1990s in the State happened despite declining share of central revenues due to its low buoyancy.

It is important to note that Karnataka does not strictly follow the central pay scales and allowances and unlike many other States, the pay revision in 1997-98 was not as generous as the central revision. It goes to the credit of the government and more particularly, the prudent fiscal management practiced by the Finance department that the State has managed to minimise the problems arising from the pay revision in the past by not succumbing to the populist measure of following the central pay and allowances.

In keeping with the practice of undertaking pay revision based on its own Pay Commission, the State government has appointed the Fifth Pay Commission. The Commission has to decide on the extent to which the fiscal health of the State permits increases in pay and allowances to the personnel without jeopardizing the targets set in the Fiscal Responsibility Act (FRA) of the State. The Commission has to analyse and make judgment regarding the capacity of the State to enhance pay and allowances while achieving fiscal consolidation and ensuring allocative and technical efficiency in public spending. The Pay Commission has referred the issue of the carrying capacity of the State to undertake pay revision to the National Institute of Public Finance and Policy.

This study would examine the fiscal capacity of the State Government to undertake pay revision in the state based on realistic assumptions on revenue growth, central transfers to the State and medium term targets set by the FRA. In Section II, we give an overview of the fiscal situation of the State. In section III and IV, we undertake an analysis of the revenue and expenditure profile of the State and the growth of salary expenditure. A detailed analysis of the salary expenditure and incidence of it on revenue budget of the State is also discussed in section IV. We develop various alternative scenarios of hike in salary expenditures in Section V to understand the possible impact of this hike on State's fiscal situation. Section VI, discusses the Medium Term Fiscal Plan (MTFP) of the State and develop the alternative fiscal scenarios based on assumptions on salary hike and proposed MTFP targets. Section VII sums up the findings and draws conclusions.

II. An Overview of Karnataka State Finances

An overview of the State finances of Karnataka is given in Table 1. It is seen that in 1993-94, the State government had generated a revenue surplus of 0.3 per cent of GSDP. However in subsequent years, the fiscal health of the State steadily deteriorated and by 2001-02, the State had all time high revenue deficit of 3 per cent of GSDP[2]. During this period, the fiscal deficit to GSDP ratio increased from 3.1 to as high as 5.4 per cent. The State also continued to have large primary deficits during this period, which implies that the prevailing budgetary stance of the State government had added to State's debt stock. The obvious outcome of such a fiscal imbalance was a steady increase in the outstanding debt stock. The increase in the outstanding debt to GSDP ratio was from 17.6 per cent in 1993-94 to 27.6 per cent in 2003-04. However, the debt-GSDP ratio also showed a marginal decline during the last

[2] During ten year period beginning the mid 1980's, there was a slow but steady deterioration in the revenue deficits of the States. Starting in 1997-98, however, this steady decline turned into a sharp deterioration (Finance Department, 2005, p 2).

two years. If we look at the consolidated public sector deficits including the power sector deficits vis-à-vis, the Government sector fiscal deficits, the divergence between them is declining over the years and by the end of 2003-04 (RE) both were of almost equal magnitude at around 4.2 per cent of GSDP (Figure 1).

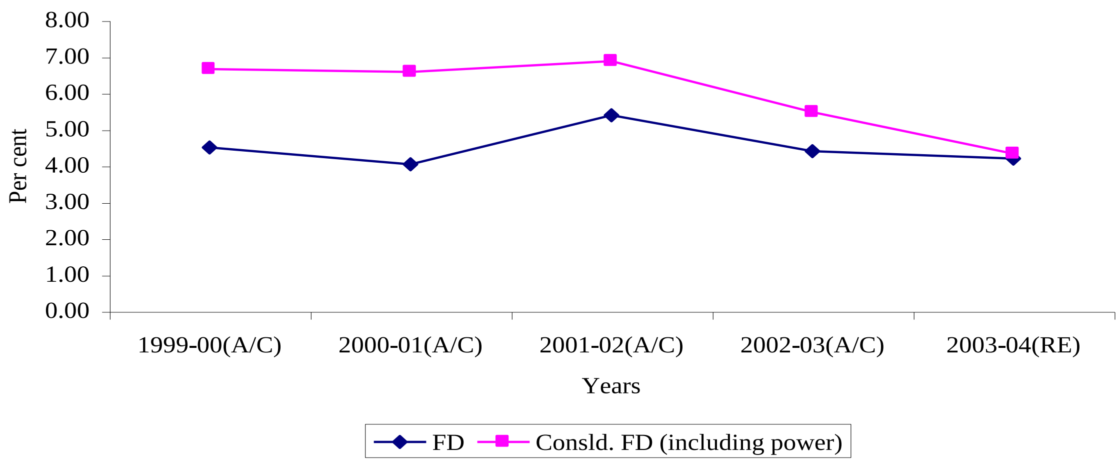
Table 1: State Finance of Karnataka: An Overview

(percent to GSDP)

	1993-94	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06 RE	2006-07 BE
Revenues	**14.8**	**13.9**	**12.3**	**13.0**	**13.6**	**14.0**	**13.2**	**14.6**	**16.7**	**16.4**	**17.9**
Own Revenues	**10.5**	**9.9**	**9.1**	**9.3**	**9.7**	**10.0**	**9.5**	**10.7**	**12.6**	**12.5**	**12.9**
Own Tax Revenues	9.3	8.8	7.9	8.2	8.6	9.0	8.7	9.5	10.8	11.7	12.1
Own Non Tax Revenues	1.2	1.1	1.2	1.1	1.0	1.0	0.8	1.2	1.8	0.8	0.9
Central Transfers	**4.3**	**4.0**	**3.2**	**3.7**	**3.9**	**4.0**	**3.7**	**3.9**	**4.1**	**3.9**	**5.0**
Share in Central Taxes	2.5	3.0	2.2	2.2	2.5	2.4	2.3	2.4	2.6	2.3	2.5
Grants	1.9	1.0	1.0	1.5	1.5	1.6	1.4	1.5	1.4	1.6	2.5
Expenditures	**17.9**	**16.2**	**15.8**	**17.5**	**17.6**	**19.4**	**17.6**	**18.0**	**19.1**	**19.3**	**20.7**
Revenue Expenditure	14.6	14.3	13.7	15.5	15.4	17.0	15.4	15.0	15.6	15.7	17.1
Interest Payment	1.7	1.9	1.8	2.1	2.3	2.5	2.7	2.8	2.6	2.3	2.3
Pension	1.1	1.2	1.2	1.7	1.5	1.5	1.6	1.4	1.5	1.4	1.4
Salary	4.7	4.6	4.3	4.8	4.4	4.6	4.1	4.0	3.6	3.5	3.8
Capital Expenditure	**3.3**	**1.8**	**2.2**	**2.1**	**2.3**	**2.4**	**2.2**	**3.0**	**3.5**	**3.6**	**3.6**
Capital Outlay	2.9	1.7	2.0	1.9	1.9	1.9	2.4	2.3	3.1	3.4	3.5
Net Lending	0.4	0.2	0.2	0.2	0.4	0.4	-0.3	0.7	0.4	0.2	0.1
Revenue Deficit	-0.3	0.4	1.4	2.4	1.8	3.0	2.2	0.4	-1.1	-0.7	-0.8
Fiscal Deficit	3.1	2.2	3.5	4.5	4.0	5.4	4.4	3.4	2.4	2.8	2.8
Primary Deficit	1.3	0.3	1.7	2.4	1.8	2.9	1.7	0.6	-0.1	0.6	0.5
Outstanding Debt	17.6	17.7	17.5	19.7	21.2	24.9	26.2	27.6	31.4	30.7	30.3

Source (Basic Data): Finance Accounts and Karnataka Budget 2005-06

Figure 1: Fiscal Deficit and Consolidated Fiscal Deficit to GSDP Ratio: A Comparison

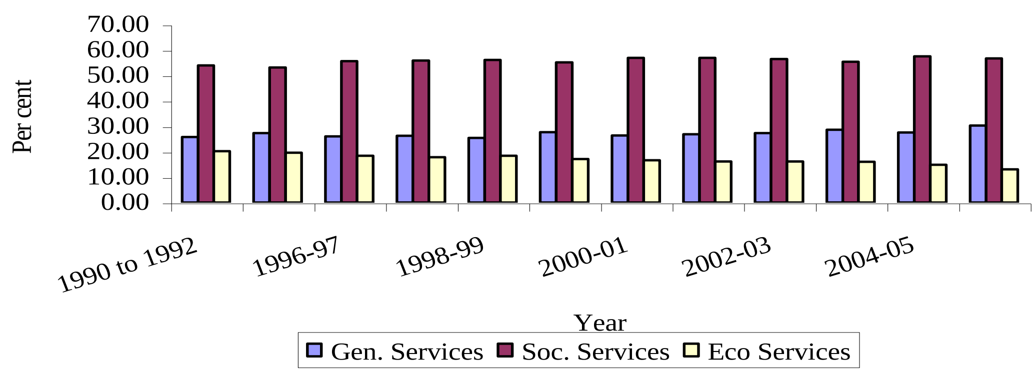


What explains the observed trend in fiscal imbalance can be understood from the disaggregated profile of revenues and expenditures. The revenue profile of the State showed a decline in the aggregate revenue-GSDP ratio from 14.8 in 1993-94 to 13.2 per cent in 2002-03. Though there was significant improvement in revenue effort in subsequent years, the decline in revenue effort during the nineties was particularly due to a marginal decline in both the non-tax revenues as well as the central transfers. During this period own tax revenues remained stagnant at around 8.2 per cent of GSDP. It has been highlighted that stagnant revenue effort during the 1990's was due to the insufficient tax effort and erosion of tax base due to the granting of tax incentives to the industries (Finance Department, 2005, p 2). The improvement in the revenue performance in recent years is particularly due to the significant revenue gain out of own tax revenues. This may be attributed to the various revenue reform measures initiated at the State level.

However, when we look at the expenditure side, increase in the revenue expenditure remained unabated while the capital expenditure declined between 1993-94 and 2001-02. During this period, interest payment and pension also has increased in relation to GSDP. Increase in interest payment was due to the increase in debt stock and also due to the increase in the average cost of debt. However some compression of revenue expenditure is observed in later years with a corresponding increase in the capital expenditure. The capital expenditure as a percentage of GSDP increased from 2.1 per cent in 1999-00 to 3.6 percent in 2005-06. One of the principal reasons for the increase in revenue expenditure is attributed to the uncontrolled recruitment and revision of salaries by the State Governments consequent to the Union Government implementing Fifth Pay Commission award for its employees (Finance Department, 2005, p 2). However as evident from the table 1, the aggregate salary expenditure as a percentage of State GSDP did not show a sharp increase over the years mainly due to the fact that the State government did not adopt central pay scales and allowances. Though it declined from 4.7 to 4.3 per cent of GSDP between 1993-94 and 1998-99 it increased to 4.8 per cent of GSDP in the year 1999-2000. Thereafter it started declining gradually, particularly due to the steady decline in the growth of employment in recent years (See Section III). In 2005-06, salary expenditure to GSDP ratio is estimated to be 3.5 per cent. Thus, if we look at it intertemporally, the salary expenditure to GSDP ratio declined by 1.2 percent during the period, 1993-94 to 2005-06.

Figure 2 shows the structure of salary expenditure between general, social and economic services for the period 1990 to 2005-06. The distribution of salary expenditure has shown little variation throughout the period. It is also seen that the share of salary in social services has dominated over those in general services and economic services. While salary on social services constituted almost 50 to 52 per cent of total salary expenditure all along this period, that on economic services exhibited a consistent decline from 20 per cent in 1990-91 to 13 per cent in 2005-06. On the other hand, salary outlay on general services, as a share of total salary expenditure increased by 6 percentage points during the 15-year period.

Figure 2: Percentage Composition of Salaries



III. Revenue Profile of the State

Before we analyse the expenditure profile and the incidence of salary expenditure thereon, in this section we examine in detail the revenue performance of the State in recent years. This is particularly important since for prudent management of public finances, salary induced hike in expenditure should be financed from current revenues rather than from the borrowed funds because, salary expenditure by its very nature is consumption expenditure. Debt financing of salary expenditure is clearly unsustainable. Before we examine the revenue performance, the changing structure of the own tax revenues is given in Table 2.

As is well known, like in other States in India, the composition of own tax revenues is dominated by the sales tax.[3]. The next major revenue source is State excise duties. Other revenues of the State come from taxes on vehicle, stamp duties and registration fees and other minor taxes. Although, the structure of taxes itself does not say much on the revenue performance of a particular State, it gives a fair idea of the taxes that are having higher weights in the total tax kitty. It is necessary to note that share of sales tax in total tax revenues of Karnataka declined by 4.5 percent along with an increase of 4.9 percent in the share of stamp duty and registration fee in the total tax revenues[4] between 1993-94 and 2005-06.

Table 2: Composition of States' Own Tax Revenues

(Per cent)

	1993-94	1997-98	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06 RE	2006-07 BE
Own Tax Revenues	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100	100	100
Sales Tax	59.8	59.7	60.5	59.6	53.5	52.4	52.9	54.1	55.3	55.2
State Excise Duties	16.8	13.5	15.7	16.8	20.1	20.1	18.6	17.5	17.2	18.0
Taxes on Vehicles	6.8	6.9	5.8	5.5	7.2	6.5	6.4	6.1	5.9	5.7
Stamp Duty Fees	6.3	9.5	7.3	7.1	8.7	10.7	10.8	10.9	11.2	11.5
Other Taxes	10.4	10.4	10.7	11.0	10.5	10.4	11.4	11.3	10.4	9.6

Source (Basic Data): http://fincomindia.nic.in/st_fprof_data/st_kar.pdf and Karnataka Budget 2005-06

If we look at the own tax revenue growth (Table 3), it has been particularly high during 2003-04 to 2005-06. The average rate of growth of own tax revenues was around 23 per cent per annum during this period. This increase in own tax revenue growth was particularly due to the higher buoyancy of sales tax, motor vehicle tax and stamp duty and registration fees.

Table 3: Growth Rate of Tax Revenues

	1994-95	1997-98	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06 RE	2006-07 BE
State's Own Tax Revenues	12.5	11.2	11.5	16.8	9.0	6.0	20.4	27.9	21.4	15.5
Sales Tax	10.0	9.1	9.8	15.0	-2.2	3.9	21.5	30.8	24.1	15.2
State Excise Duties	11.6	2.3	20.9	25.3	29.8	5.9	11.4	20.2	19.3	21.3
Taxes on Vehicles	12.0	36.4	16.0	11.8	42.0	-5.1	18.4	22.9	17.8	11.0
Stamp Duty & Reg. Fees	54.7	25.0	3.2	12.8	34.0	30.4	21.5	29.8	23.9	18.6
Other Taxes	3.0	10.9	12.7	19.5	4.7	4.0	32.4	27.4	11.1	7.3

Source (Basic Data): http://fincomindia.nic.in/st_fprof_data/st_kar.pdf and Karnataka Budget 2005-06.

[3] Sales tax has been replaced by the value-added tax in the year 2005-06.

[4] Radical reforms initiated in Stamps and Registration, targeted to correct the existing situation of high tax rates and undervalued tax base, have more than doubled the realisation in last three years. Revision of market value of properties has been carried out to bring the guidance values in line with the actual market rates. After two years the Central Valuation Committee has become functional and an exhaustive database of the properties is prepared during the process of revision. But it is felt that even now the guidance values are low as compared to the market rates. It is expected that only after several rounds of revision would the guidance values come at par with the market rates (Finance Department, 2005, p 21)

If we look at the period wise buoyancy of taxes (Table 4), the buoyancy of all the taxes are significantly above unity during 2000-01 to 2005-06. This period coincides with the period of fiscal reform initiatives in the State. The positive effect of revenue reform is visible in the post reform period. This is particularly evident if we compare the revenue buoyancy of individual taxes in the pre and post reform period. Thus, it can emphatically be said that, one of the principal reasons for the improvement in fiscal imbalance profile in recent years is the better own tax revenue performance of the State.

Table 4: Buoyancy of Taxes

	1993-94 to 2005-06	1993-94 to 1999-00	2000-01 to 2006-07
Own Tax Revenue	1.084	0.823	1.548
Sales Tax	1.011	0.873	1.414
State Excise Duties	1.191	0.662	1.516
Motor Vehicle Tax	0.976	0.545	1.595
Stamp Duty and Registration Fees	1.343	0.882	2.500
Other Taxes	1.144	0.924	1.483

Source (Basic Data): http://fincomindia.nic.in/st_fprof_data/st_kar.pdf and Karnataka Budget 2005-06

In case of non-tax revenues, we have observed that the non-tax revenue to GSDP ratio is very low in Karnataka and it has declined over the years. It has been noted by Rao (2003) that one of the important reasons for revenue imbalance in the State has been the steadily declining contribution from non-tax revenues, despite large investment in irrigation, water supply and sanitation, higher and technical education and various other public enterprises. The State has not been able to effect adequate cost recoveries to make these activities viable and to generate resources for additional reinvestment in these sectors. This has particularly been due to the low user charges and inability of the government to revise them at periodic intervals. However, as mentioned in the MTFP 2005-09 policy statement, this problem has been tackled to a large extent in past few years when most of the user charge rates have undergone one round of revision. If we look at the composition of non-tax revenues (Table 5), the share of interest receipts in total non-tax revenues has declined steadily over the years with a corresponding increase in the share of receipt for other general, social and economic services[5].

[5] The interest earning and the lottery receipts are adjusted for contra entries and lottery expenditures respectively.

Table 5: Composition of States' Own Non-Tax Revenues

	1993-94	1997-98	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05 RE	2005-06 BE	2006-07 BE
Own Non Tax Revenues	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Interest Receipts	47.2	45.8	51.4	44.2	13.4	3.0	7.2	5.3	6.5	10.2
Dividends	0.6	0.4	0.4	0.2	0.5	1.3	1.1	0.6	1.0	1.0
Royalty *	5.8	9.9	7.5	8.4	13.8	13.7	14.3	10.6	16.2	19.9
Forestry and Wild life	12.8	9.3	6.1	6.6	9.5	8.9	11.7	6.2	8.7	9.7
Irrigation(Major, Medium & Minor)	2.0	1.6	1.1	1.3	2.2	2.1	1.0	0.6	2.6	2.7
Lottery(Net)	0.7	0.2	0.2	0.3	-0.2	0.6	7.3	3.5	-9.3	6.9
Other General Services	6.6	8.4	6.2	9.6	13.0	18.4	16.9	9.9	34.9	6.8
Other Social Services	7.4	13.1	6.9	7.5	13.5	16.2	8.0	5.4	10.9	7.6
Other Economic Services	16.9	11.3	20.2	21.9	34.3	35.7	32.5	58.0	28.4	35.3

Source (Basic Data): http://fincomindia.nic.in/st_fprof_data/st_kar.pdf and Karnataka Budget 2005-06
*Petroleum, Coal & Lignite and Metallurgical industries

IV. Expenditure Profile of the State

Having discussed the revenue side of the State budget, in this section we undertake a disaggregated analysis of the State Government expenditure with a focus on growth and incidence of salary expenditure on the revenue budget of the State. The structure of government expenditure presented in Table 6 reveals that the share of revenue expenditure has increased from 78.9 to 82.2 per cent between 1993-94 and 2005-06 primarily due to the increase in the non-plan revenue expenditure driven by interest payment, pension and salaries. The interest payment component of non-plan revenue expenditure increased sharply from 9.1 per cent in 1993-94 to 15.5 per cent in 2003-04 before showing signs of decline. During the same period, the share of capital expenditure in total expenditure has declined from 21 to 18 per cent. Within the revenue expenditure, the share of plan revenue expenditure remained as low as around 18 per cent and showed a marginal decline during this period. It may also be noted that aggregate expenditure elasticity (Table 7) during the post fiscal reform period was higher than the period before. However if we look at the primary expenditure excluding pension, the elasticity has been 1.279 during the post reform period compared to 0.848 in the pre reform period. In other words, the expenditure buoyancy for discretionary government expenditure has increased during the post fiscal reform period in Karnataka. This is primarily due to the increase in capital expenditure to GSDP ratio during the post reform period. This is also a sign of greater fiscal space, possibly may be attributed to the greater revenue mobilization in the post fiscal reform period.

Table 6: Structure of Government Expenditure

(Per cent)

	1993-94	1997-98	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06 RE	2006-07 BE
Revenue Expenditure	81.4	88.7	88.3	87.2	87.8	87.5	83.3	81.5	81.5	82.5
General Services	25.7	30.0	31.7	30.4	29.2	32.1	32.0	28.5	27.0	27.3
Interest Payment	9.8	11.8	12.1	12.9	12.7	15.6	15.6	13.4	11.9	11.3
Pension	5.9	7.2	9.7	8.8	7.9	9.1	8.0	7.6	7.2	6.9
Social Services	32.3	35.1	32.9	33.2	30.4	30.0	29.2	27.2	28.3	29.1
Education	16.9	18.0	17.6	18.5	16.2	16.5	15.4	15.1	14.9	13.7
Medical and Public Health	5.3	5.3	5.2	4.9	4.7	4.5	4.0	3.7	3.6	3.5
Economic Services	21.7	21.3	21.1	20.8	25.5	22.7	19.5	23.0	22.7	22.2
Compensation and Assignment to LBs	1.7	2.3	2.5	2.9	2.7	2.7	2.6	2.8	3.6	4.0
Capital Expenditure	18.6	11.3	11.7	12.8	12.2	12.5	16.7	18.5	18.5	17.5
Capital Outlay	16.2	10.3	10.7	10.6	9.9	13.9	12.7	16.5	17.5	17.0
Net Lending	2.5	1.0	1.0	2.2	2.3	-1.4	4.0	2.0	0.9	0.5
total Expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source (Basic Data): http://fincomindia.nic.in/st_fprof_data/st_kar.pdf and Karnataka Budget 2005-06

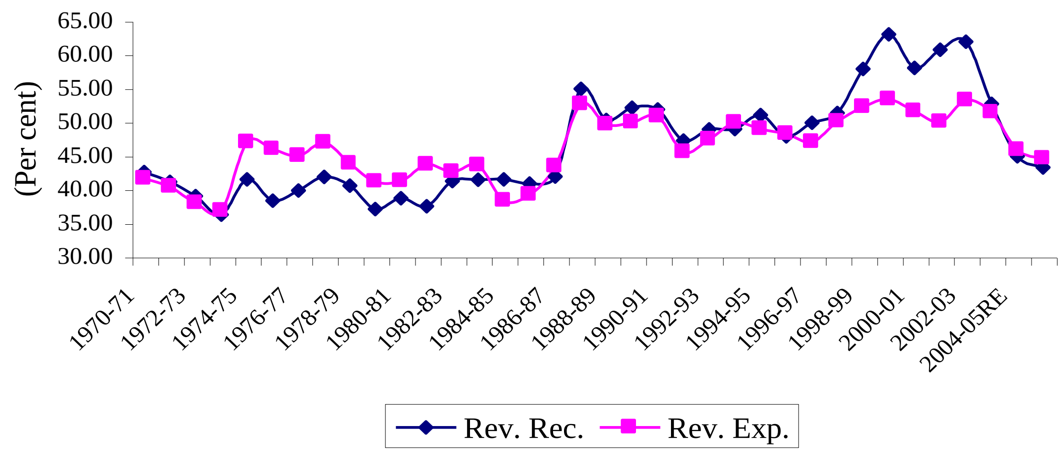
Table 7: Expenditure Elasticity: Various Components

	1993-94 to 2005-06	**1993-94 to 1999-00**	**2000-01 to 2005-06**
Total Expenditure	1.098	0.922	1.194
Revenue Expenditure	1.084	1.003	1.058
Capital Expenditure	1.174	0.455	1.957
Primary Expenditure Excluding Pension	1.054	0.848	1.279
Primary Revenue Expenditure Excluding Pension	1.026	0.934	1.120

Source (Basic Data): Finance Accounts and Karnataka Budget 2005-06

In order to find out the impact of salary and other committed expenditures on the revenue budgets of the State, we have estimated the share of committed expenditures in total revenues and revenue expenditures of the State of Karnataka for the period between 1970-71 and 2005-06 based on the data obtained from the Fifth Pay Commission of Karnataka on salary expenditure. The committed expenditure is defined as the spending on account of interest payment, wages and salaries and pension which are largely beyond the control of the government to compress during the budget year. This is particularly important, as the fiscal space that is available to the State for a salary hike, one needs to examine the resources that have to be set aside to meet commitments on interest payment, salary and pension from the revenue budget of the State. As can be seen from the figure 3, the share of committed expenditures as a percentage of revenue receipts and revenue expenditure has declined sharply during the last couple of years after reaching an all time high of more than 65 per cent of revenue receipts of the State during 1999-00. It is interesting to note that up to 1984-85, the share of committed expenditure in revenue receipts was lower than the revenue expenditures and it remained below 40 per cent of the total revenue receipts. However, the incidence of committed expenditure increased sharply thereafter and reached its peak at the end of the decade of 1990's driven by the increase in salary expenditure and interest payment. As mentioned earlier, increase in interest payment was not due to the large debt overhang but also due to the higher cost of debt.

Figure 3: Incidence of Committed Expenditures on Revenue Budget of the State: 1970-71 to 2005-06



As our focus is the salary component of government expenditure, we examine how the growth in government sector employment has contributed to salary expenditure. We have presented average annual growth rates of employment and salary expenditure for ten year periods, and the share of the latter on revenue receipts and revenue expenditure of the State of Karnataka (Table 8) for corresponding period. It is evident that the rate of growth of employment in government was the lowest during the nineties at 2.93 per cent compared to 3.55 and 3.57 during the seventies and the eighties respectively. Between 2000-01 and 2005-06, yearly growth of employment was negative in all the years, except for 2002-03 and 2005-06. If we look at the growth of salary expenditure also, it has particularly been lower during this period. If we look at the decadal rate of growth of salary expenditure, the growth was particularly high during the eighties at 18.49 per cent compared to 14.69 per cent during the nineties. Despite higher per-employee salary expenditure during the 1990's, decline in the growth of salary expenditure during this period can be attributed to the lower growth of employment during the 1990's.

Table 8: Growth of Employment and Salary

(Per cent)

	Annual Growth of Employment	Annual Growth of Salary Expenditure	Salary as a percentage of	
			Revenue Receipts	Revenue Expenditure
1970-71 to 1979-80	3.55	13.90	28.91	31.41
1980-81 to 1989-90	3.57	18.49	31.65	31.48
1990-91 to 1999-00	2.93	14.69	32.04	30.19
2000-01	-1.94	1.19	31.24	27.75
2001-02	-0.27	7.45	32.47	26.74
2002-03	0.71	-0.69	30.56	26.26
2003-04	-0.07	7.73	25.64	25.01
2004-05 RE	-1.65	3.89	21.84	22.29
2005-06 BE	2.28	11.56	21.11	21.75
1970-71 to 2005-06	2.70	14.63	28.67	27.27

Source: Karnataka Fifth Pay Commission

In order to have an idea of the employment and salary profile of Karnataka vis-à-vis other States, we have used the data given in the Twelfth Finance Commission Report on salary expenditure and employee profiles across States. It is evident from the Table 9, that there are wide variations across States in the growth of employment during the period from 1993-94 to 2002-03. Secondly, if we look at the average growth of employment across States prior to and after the implementation of the Central Fifth Pay Commission's recommendation, we find that in the later years, i.e., between 1999-00 and 2002-03, the average rate of growth of employment was negative in many States, particularly in Andhra Pradesh, Bihar, Orissa and Uttar Pradesh, the rates of growth of employment were –4.53, -4.09, -2.18 and –3.22 per cent respectively. However in Karnataka, the rates of growth of employment during the same period was positive at 2 per cent. The other States with positive rates of growth of employment during this period were Gujarat, Haryana, Punjab, Rajasthan, Tamil Nadu and West Bengal.

The annual average rate of growth of per employee salary expenditure shown in Table 10 also reveals a wide variation. There have been wide disparities in per employee salary expenditure across States with the maximum to minimum ratio varying on an average at more than 1.7. Also, disparities in per employee salary expenditures have tended to increase in recent years. When we look at the average salary expenditure growth in pre and post 5th Central Pay Commissions' recommendations induced hike in salary expenditure, we find that in most of the States, the post salary revision growth has been significantly higher. For Karnataka however, it has been lower than the pre-reform period.

Table 9: Annual Average Growth Rate of Employment

(Per cent per annum)

	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	1995-98	1999-03
Andhra Pradesh	0.79	0.77	22.62	-15.43	-1.45	-6.59	-5.34	6.16	8.06	-4.53
Assam	2.23	1.81	2.61	4.10	-1.40	-1.28	-1.29	-1.38	2.22	-0.25
Bihar	-2.32	-2.91	-4.26	-3.89	-3.00	-3.00	-8.70	-1.85	-3.16	-4.09
Gujarat	-0.57	-2.07	-3.22	9.16	-4.56	-0.05	2.46	-3.66	-1.95	0.67
Haryana	2.93	1.72	-0.42	0.85	1.28	-0.46	1.00	1.00	1.41	0.73
Karnataka	6.44	3.46	-13.60	7.33	3.54	-1.35	-0.24	0.73	-1.23	2.00
Kerala	1.49	-0.39	1.79	2.58	3.32	-1.11	0.17	-8.59	0.96	-0.73
Madhya Pradesh	0.53	-2.22	-0.23	0.96	-0.41	-1.18	-0.87	-1.52	-0.64	-0.61
Maharashtra	1.46	-1.45	0.05	-1.01	-3.05	0.49	-2.10	-0.52	0.02	-1.24
Orissa	4.79	7.38	2.32	1.46	-3.64	-5.45	-1.52	-1.74	4.83	-2.18
Punjab	0.61	1.50	-0.54	0.49	1.31	-1.18	0.67		0.53	0.32
Rajasthan	3.71	3.73	3.36	2.96	1.65	0.79	1.79	-0.67	3.60	1.30
Tamil Nadu	0.14	0.02	0.00	2.39	0.07	0.04	0.09		0.05	0.65
Uttar Pradesh	-0.93	-5.78	-0.70	-0.70	-12.25	-0.38	0.45	0.00	-2.47	-3.22
West Bengal	-0.02	0.30	-0.49	1.09	0.17	0.95	0.31	-0.73	-0.07	0.36
All States	1.28	0.02	0.55	-0.02	-1.65	-1.31	-1.06	-0.67	0.62	-0.94

Source: Twelfth Finance Commission Report

Table 10: Annual Average Growth Rate of Per Employee Salary Expenditure

(Per cent per annum)

	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	1995-98	1999-03
Andhra Pradesh	8.24	7.54	-7.11	29.72	28.98	18.57	0.71	6.60	2.89	16.92
Assam	12.80	9.86	11.98	13.01	26.29	5.97	5.57	2.42	11.55	10.65
Bihar*	13.81	8.75	17.71	21.39	29.53	-0.45	-21.98	7.63	13.43	7.22
Gujarat	26.33	6.62	19.58	12.45	7.81	3.88	2.61	11.69	17.51	7.69
Haryana	13.56	14.63	-1.26	37.17	19.44	2.73	10.01	9.43	8.98	15.75
Karnataka	5.59	11.62	36.55	5.67	16.24	2.89	8.97	0.63	17.92	6.88
Kerala	5.44	13.65	4.32	17.37	33.08	0.32	-8.92	18.80	7.81	12.13
Madhya Pradesh*	14.63	14.26	11.36	26.89	10.17	5.85	-7.63	15.07	13.42	10.07
Maharashtra	14.01	8.01	9.19	11.94	52.97	-11.77	3.06	-4.27	10.40	10.39
Orissa	8.35	23.31	14.99	30.09	22.25	2.10	-5.10	17.94	15.55	13.46
Punjab	13.71	20.97	23.53	27.78	2.53	13.44	-4.25		19.40	9.87
Rajasthan	14.22	11.27	7.96	36.44	4.34	0.28	2.29	4.14	11.15	9.50
Tamil Nadu	16.73	17.15	16.24	27.28	12.16	-1.02	1.51		16.71	9.98
Uttar Pradesh*	14.87	23.79	30.89	6.65	25.82	5.58	-10.06	14.35	23.18	8.47
West Bengal	9.54	14.38	10.10	46.60	10.84	6.88	-1.66	5.19	11.34	13.57
Max/Min	1.73	1.73	2.11	2.55	1.98	1.69	1.57	1.50	1.85	1.86

Source: Twelfth Finance Commission Report

In order to understand the relative position of Karnataka, vis-à-vis other States in terms of incidence of committed expenditures including the salary expenditure, we have presented their combined share in the revenue budget individual States. As may be seen from Table 11, the share varied widely across States. In Karnataka, there has been a marginal increase in the share of committed expenditures in 2000-01 and 2003-04 in relation to the period from 1997-98 to 1999-00, judged both in relation to revenue receipts and revenue expenditures. In terms of incidence of committed expenditures, most of the States are fiscally stressed. Strikingly, it is the poorer and fiscally profligate States that had higher stress of committed expenditures. Compared to many of these States, Karnataka's relative position was much better in terms of incidence of committed expenditures.

We have observed that in Karnataka (See Figure 3), the share of these committed expenditures in total revenues showed a sharp decline in recent years. In terms of revenue expenditure also, the combined share of committed expenditure declined in recent years but nevertheless, constituted around 45 per cent of the total revenue expenditure. As the committed expenditure share is on the decline one can argue that fiscal space available for discretionary government expenditure, which are mostly developmental, is on the increase. However any salary hike without a corresponding revenue growth would mean a shrinking of fiscal space for developmental spending. At the same time one needs to appreciate the concern of salary hike with a reasonable growth of employment under various sectors within the government. In the next subsection we will examine in further details the scale wise employment and salary expenditure growth of the State government and the scope for increase thereon.

Table 11: Incidence of Committed Expenditures on Revenue Budget: An Interstate Comparison

(In Per cent)

	1994-95 to 1996-97	1997-98 to 1999-00	2000-01 to 2003-04
Committed Expenditure as a Percentage of Revenue Receipt			
Andhra Pradesh	61.38	62.37	65.82
Assam	76.70	87.08	86.63
Bihar	86.43	95.85	95.38
Gujarat	34.76	41.24	46.50
Haryana	63.44	78.43	79.72
Karnataka	52.21	60.69	63.05
Kerala	75.05	86.99	93.39
Madhya Pradesh	53.01	61.63	72.94
Maharashtra	61.86	75.55	82.82
Orissa	77.04	102.53	97.76
Punjab	80.85	105.25	104.84
Rajasthan	67.49	91.21	89.43
Tamil Nadu	62.17	79.14	81.04
Uttar Pradesh	75.12	92.07	84.75
West Bengal	82.99	119.00	122.38
Committed Expenditure as a percentage of Revenue Expenditure			
Andhra Pradesh	53.09	56.55	57.96
Assam	75.04	83.26	76.84
Bihar	77.02	77.39	84.20
Gujarat	34.04	34.47	36.11
Haryana	55.86	63.48	72.13
Karnataka	50.57	54.67	55.37
Kerala	68.84	66.49	69.99
Madhya Pradesh	49.06	52.44	59.61
Maharashtra	59.60	65.12	65.15
Orissa	65.39	74.26	75.77
Punjab	68.44	77.24	75.56
Rajasthan	61.42	71.82	70.81
Tamil Nadu	58.77	65.46	68.52
Uttar Pradesh	63.84	67.48	63.33
West Bengal	70.04	75.56	78.15

Source: Twelfth Finance Commission Report

Structure of Employment and Scale

As evident from the Table 12, the government of Karnataka currently has 20 different scales, apart from the all India scales of IAS/IPS and temporary employees on consolidated pay. The mean basic salary varies from Rs. 3175 in the lowest scale of Group-D employees to Rs. 16, 840 for highest scale of Group-A employees. As evident from the table, the bulk of the employment is in Group- C.

Table 12: Pay Scales, Mean Basic Pay and Distribution of Employees: 2005-06

Pay Scales	Mean Basic Pay (In Rs)	Scalewise Employee Distribution (In Per cent)
Group-D		
2500-50-2700-75-3450-100-3850	3175	7.65
2600-50-2700-75-3450-100-4350	3475	4.39
Group-C		
2775-75-3450-100-4450-125-4950	3863	2.36
3000-75-3450-100-4450-125-5450	4225	19.72
3300-75-3450-100-4450-125-5700-150-6300	4800	11.80
3850-100-4450-125-5700-150-7050	5450	11.06
4150-100-4450-125-5700-150-7200-200-7800	5975	7.58
4575-125-5700-150-7200-200-8400	6488	6.90
5200-125-5700-150-7200-200-8800-260-9580	7390	4.01
Group-B		
5575-125-5700-150-7200-200-8800-260-10620	8098	3.45
6000-150-7200-200-8800-260-10880-320-11200	8600	3.11
6300-150-7200-200-8800-260-10880-320-11840	9070	4.12
Group-A		
7400-200-8800-260-10880-320-13120	10260	1.95
8000-200-8800-260-10880-320-13440	10720	0.54
9580-260-10880-320-13440-380-14200	11890	4.71
10620-260-10880-320-13440-380-14960	12790	0.11
11520-320-13440-380-14960-440-15840	13680	0.01
12800-320-13440-380-14960-440-16720	14760	0.05
13820-380-14960-440-16720-500-17220	15520	0.04
14960-440-16720-500-18720	16840	0.16
All India Scales (IAS, IPS & IFS)	0	0.09
Other Scales if any	0	6.09
Local Candidates(Consolidates Pay)	0	0.10

Source: Karnataka Fifth Pay Commission

Like many other States, Karnataka also provides salary support to the Zilla Panchayat's in addition to the State sector. If we look at the scale wise distribution of employees (Table 13), it is the Group C that constitutes the bulk of employment in both the sectors. The scale wise distribution of employees also shows that the share of Group C employees in total employment has increased from 61.7 per cent in 2000-01 to 67.65 per cent in 2004-05, with a subsequent decline to 63.43 per cent in 2005-06. However, if we look at the scale wise growth of employment in the State sector, the growth is highest in the IAS/IPS category at 12.2 per cent, followed by employment in Group B at 5.47 per cent. The rates of growth of employment in rest of the scales were negative. However in the Zilla Parishad (ZP) sector, rates of growth of employment in all the groups were positive except in the others category. It is to be noted that employment growth in State sector, ZP sector and both the sectors taken together were –0.76, 0.71 and 0.05 respectively.

Table 13: Structure and growth of Employment by Scale

(In Per cent)

	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	TGR
State Sector							
Group A	4.13	5.58	4.11	4.15	4.27	4.84	-0.79
Group B	7.90	7.04	6.32	6.40	9.14	10.32	5.47
Group C	67.80	73.62	68.66	75.49	67.99	67.99	-1.13
Group D	18.62	12.22	18.58	11.65	17.28	16.52	-0.84
IAS/IPS	0.00	0.09	0.07	0.06	0.05	0.20	12.20
Others	1.54	1.45	2.26	2.25	1.27	0.14	-30.60
Total	288668 (100)	285273 (100)	288678 (100)	289047 (100)	282828 (100)	274950 (100)	-0.76
ZP Sector							
Group A	2.41	2.43	2.09	2.08	2.14	9.69	21.50
Group B	10.83	10.57	14.16	11.65	11.95	10.96	1.37
Group C	56.47	74.46	69.95	71.06	67.36	59.92	0.74
Group D	8.34	5.66	8.66	5.28	8.59	8.59	3.35
IAS/IPS	0.00	0.01	0.01	0.01	0.01	0.01	0.00
Others	21.95	6.87	5.13	9.91	9.95	10.83	-4.24
Total	338231 (100)	339926 (100)	340979 (100)	340151 (100)	335998 (100)	357995 (100)	0.71
Total							
Group A	3.20	3.87	3.02	3.03	3.11	7.58	11.08
Group B	9.48	8.96	10.56	9.24	10.67	10.68	2.90
Group C	61.68	74.08	69.36	73.09	67.65	63.43	-0.18
Group D	13.08	8.65	13.21	8.21	12.56	12.04	0.70
IAS/IPS	0.00	0.04	0.04	0.03	0.03	0.09	11.61
Others	12.55	4.40	3.81	6.39	5.98	6.18	-5.78

Total	626899 (100)	625199 (100)	629657 (100)	629198 (100)	618826 (100)	632945 (100)	0.05

Source: Karnataka Fifth Pay Commission

The salary structure comprises of Basic Pay, Dearness Allowance (DA) and Other Allowances (OA). As can be seen from the Table 14, in the year 2005-06, basic pay constituted 55 per cent, DA constituted 39 per cent and OA constituted 6 per cent of the total salary. Dearness allowance constituted 71 per cent of the basic and other allowances like the house rent allowance and traveling allowance together worked out to be 11 per cent of the basic pay.

Table 14: Structure of Salary

(Per cent)

	PAY	IR	DA	OA	TOTAL
1990-91	69	0	25	6	100
1991-92	63	0	31	7	100
1992-93	56	0	38	6	100
1993-94	50	3	40	7	100
1994-95	49	0	45	6	100
1995-96	43	0	51	5	100
1996-97	39	0	55	6	100
1997-98	36	3	55	6	100
1998-99	37	6	51	6	100
1999-00	69	0	27	4	100
2000-01.	66	0	29	5	100
2001-02	65	0	30	5	100
2002-03	63	0	32	5	100
2003-04	60	0	34	5	100
2004-05	58	0	36	6	100
2005-06	55	0	39	6	100

Source: Karnataka Fifth Pay Commission

V. The Fiscal Implications of Salary Hike: The Base Scenario

In order to find out the fiscal implications of salary hike, we have developed alternative scenarios of salary increase and imputed the proposed hike in salary in the revenue budget of the State to understand its impact on the fiscal imbalance of the State. The first scenario termed as the base scenario projects the fiscal profile of the State and the salary expenditure thereon on the basis of the historical growth rates of various components of revenues and expenditures, including the salary expenditure. All the growth rates and the buoyancy estimates used in this exercise are based on the data for the period from 1993-94 to 2005-06.

The revenue side projection in this scenario is developed on the basis of historical buoyancies of major taxes and own non-tax revenues. The tax devolution and grants are projected to grow at the historical rate of 10.8 and 13.5 per cent per annum respectively. The historical trend rate of growth of aggregate salary expenditure was 9.91 per cent, though there were inter-sectoral variations. For example, the growth of salary expenditure was 11.21 per cent in the education sector and also 10.63 per cent in general services. In other sectors, the growth has been around 9 per cent except in the case of economic services where the growth in salary expenditure was 8.26 per cent during this period.

The historical buoyancy of taxes presented in Table 4 is used for own tax revenue projections. Interest payment on the stock of debt is assumed to be charged at the base year effective rate of interest of 11.01 per cent. Pension payment is expected to grow at the rate of 15.83 per cent per annum, the historical rate of pension growth observed between 1993-94 and 2005-06. Non-salary component of social and economic services is assumed to grow at their historical rates.

Based on the assumptions delineated above, we have arrived at a fiscal profile of the State for the period between 2006-07 and 2015-16. Ten-year projections of fiscal profile seemed to be appropriate, given the periodicity of the appointment of Pay Commissions. Also a reasonably long fiscal profile would help in bringing out the long run fiscal implications of a salary-induced hike in revenue expenditure.

The base scenario as developed shows that between 2006-07 and 2015-16 revenue receipts as a percentage of State GSDP will increase from 16 to 16.8 per cent. Revenue expenditure, which was at 15.4 per cent of GSDP in the base year i.e., 2005-06, would increase to 16.8 per cent. The salary expenditure as a percentage of GSDP would decline marginally during this period. However the interest payment and pension, as a percentage of GSDP will increase from 2.4 to 2.9 per cent and 1.5 to 2 per cent respectively. Capital expenditure would also show a marginal increase during this period. The observed profile of revenue and expenditures outcome is a fiscal imbalance profile, which shows an erosion of revenue surplus from – 0.51 per cent of GSDP to – 0.04 per cent of GSDP. The fiscal deficit correspondingly would increase from 2.82 to 3.68 per cent of GSDP during the same period, leading to a gradual increase in the debt stock from 27.87 per cent to 30 per cent of GSDP. This is clearly an unsustainable scenario, as the State would fail to adhere to the KFRA and the proposed MTFP targets.

Table 15: Fiscal Profile of Karnataka: The Base Scenario

(As a Per cent to GSDP)

	2005-06RE	2006-07BE	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Scenario I: Increase in Salary at Historical Trend Growth Rate											
Revenue Receipts	16.4	17.9	18.0	18.1	18.2	18.3	18.4	18.5	18.7	18.8	18.9
Revenue Expenditure	15.7	17.1	17.2	17.3	17.5	17.6	17.8	17.9	18.1	18.3	18.5
Interest Payment	2.3	2.3	2.3	2.3	2.2	2.2	2.2	2.2	2.2	2.3	2.3
Pension	1.4	1.4	1.5	1.5	1.6	1.6	1.7	1.7	1.8	1.8	1.9
Salary Expenditure	3.5	3.8	3.8	3.7	3.6	3.5	3.5	3.4	3.3	3.3	3.2
Capital Expenditure	3.6	3.6	3.7	3.7	3.8	3.9	3.9	4.0	4.0	4.1	4.2
Revenue Deficit	-0.7	-0.8	-0.8	-0.8	-0.7	-0.7	-0.6	-0.6	-0.5	-0.5	-0.4
Fiscal Deficit	2.8	2.8	2.9	3.0	3.1	3.2	3.3	3.4	3.5	3.6	3.8
Primary Deficit	0.6	0.5	0.6	0.7	0.8	0.9	1.0	1.2	1.3	1.4	1.5
Outstanding Debt	30.7	30.3	29.9	29.6	29.4	29.3	29.4	29.6	29.8	30.2	30.7
Scenario II: Increase in Basic Pay by 10 Percent											
Revenue Receipts	16.4	17.9	18.0	18.1	18.2	18.3	18.4	18.5	18.7	18.8	18.9
Revenue Expenditure	15.7	17.7	17.8	17.9	18.1	18.3	18.4	18.6	18.8	19.0	19.2
Interest Payment	2.3	2.4	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Pension	1.4	1.6	1.6	1.7	1.7	1.8	1.8	1.9	1.9	2.0	2.1
Salary Expenditure	3.5	4.2	4.2	4.1	4.0	4.0	3.9	3.8	3.8	3.7	3.7
Capital Expenditure	3.6	3.6	3.7	3.7	3.8	3.9	3.9	4.0	4.0	4.1	4.2
Revenue Deficit	-0.7	-0.2	-0.2	-0.2	-0.1	0.0	0.0	0.1	0.1	0.2	0.3
Fiscal Deficit	2.8	3.4	3.5	3.6	3.7	3.8	3.9	4.1	4.2	4.3	4.5
Primary Deficit	0.6	1.0	1.1	1.3	1.4	1.5	1.7	1.8	1.9	2.0	2.1
Outstanding Debt	30.7	30.9	31.0	31.2	31.4	31.8	32.3	32.8	33.4	34.1	34.8
Scenario III: Increase in Basic Pay by 20 Percent											
Revenue Receipts	16.4	17.9	18.0	18.1	18.2	18.3	18.4	18.5	18.7	18.8	18.9
Revenue Expenditure	15.7	18.2	18.4	18.5	18.7	18.8	19.0	19.2	19.4	19.6	19.8
Interest Payment	2.3	2.4	2.4	2.4	2.3	2.3	2.3	2.3	2.3	2.4	2.4
Pension	1.4	1.7	1.8	1.8	1.9	1.9	2.0	2.1	2.1	2.2	2.3
Salary Expenditure	3.5	4.6	4.5	4.5	4.4	4.3	4.3	4.2	4.1	4.1	4.0
Capital Expenditure	3.6	3.6	3.7	3.7	3.8	3.9	3.9	4.0	4.0	4.1	4.2
Revenue Deficit	-0.7	0.3	0.4	0.4	0.5	0.5	0.6	0.6	0.7	0.8	0.9
Fiscal Deficit	2.8	3.9	4.0	4.1	4.3	4.4	4.5	4.6	4.8	4.9	5.0
Primary Deficit	0.6	1.5	1.7	1.8	1.9	2.0	2.2	2.3	2.4	2.5	2.7
Outstanding Debt	30.7	31.4	32.0	32.7	33.4	34.1	34.9	35.7	36.5	37.4	38.4

Quantification of the impact of a differential hike in basic pay on total salary bill further extends the base scenario. The Scenario II proposes a hike of 10 per cent in basic pay and the Scenario III proposes a hike of 20 per cent on basic pay in the base year, i.e., 2006-07. The adjusted base year salary expenditure has been grown at its historical rate. The salary profile thus obtained is imputed into the base Scenario I. In case of pension also, similar adjustments are done in the base year, to obtain the future profile of pension at historical growth rates.

As can be seen from Table 15, in case of Scenario II, with a 10 per cent hike in salary and pension, the State goes into revenue deficit of 0.07 per cent of GSDP in the base year itself. The revenue deficit continues to grow and reaches at 0.53 per cent of GSDP by the end of 2015-16. The fiscal deficit and the outstanding debt also increase to 4.26 per cent and 33.55 per cent of GSDP, by the terminal year of projections. In case of Scenario II, obviously the effect of a 20 per cent salary hike is much more severe compared to Scenario I and Scenario II (See Table 15).

The scenarios as developed reveal that the fiscal strain emanating due to a salary hike at the historical growth rate is not sustainable. Thus, if a fiscally sustainable salary hike compatible with MTFP and KFRA commitments have to be undertaken, apart from the key fiscal parameters, one has to take into consideration the MTFP targets, particularly the target set for salary expenditure. In the next section we discuss the MTFP targets and develop alternative fiscal scenarios taking the MTFP norms and suggest measures for expenditure restructuring and revenue enhancement so that the proposed hike does not disturb the fiscal balance.

Section VI: Fiscal Implication of Salary Hike: The Alternative Scenario

The salient features of MTFP of 2005-09 are presented in Box 1. MTFP has assigned prescriptive buoyancies to different taxes levied by the State. Expenditure projections reveal significant compression of expenditure on salaries, pensions and subsidies. Some restructuring seems imminent with an increase in expenditure allocations on major operation and maintenance, viz., roads, buildings, irrigation, education, health, rural development, water supply, agriculture and forestry. However, one of the major weaknesses of the MTFP is its inability to contain power sector subsidy in the medium term. Power sector subsidy at Rs. 1750 crores constituted 6.2 per cent of the revenue expenditure in the year 2005-06. By the terminal year of MTFP, i.e., 2008-09, in absolute volume it will be Rs. 2100 crores constituting 5.4 per cent of the revenue expenditure. In this context it needs to be emphasised that even with a 20 per cent hike in salary expenditure in the base year, at historical growth rate the additional expenditure requirement for the salary would be Rs. 1300 crores, which is well below the subsidies given to the power sector. In other words, the argument for not awarding reasonable pay revision to the employees on the grounds of fiscal capacity constraint loses much of its force when the State government demonstrates its political unwillingness to contain the large subsidies in the power sector.

Box 1: MTFP Targets: 2006-07 to 2008-09

1. Macro Parameters

- ✓ Real growth of GSDP at 7 per cent per annum.
- ✓ Inflation rate at 5 per cent.

2. Revenue Resources

- ✓ Commercial taxes assume a buoyancy of 1.075
- ✓ The state excise duty assumes a buoyancy of 1.025.
- ✓ Stamp duty and registration fee assumes a buoyancy of 1.
- ✓ Motor vehicle tax assumes a buoyancy of 1.025.
- ✓ Other taxes assume a buoyancy of 1.

3. Expenditure Projections

- ✓ Salary expenditure broken into basic pay, dearness allowance and other allowances are projected to grow at 2.75 per cent, inflation rate and 1 per cent respectively.
- ✓ Pension payments are projected on the basis of the historical growth rates for pension payments.
- ✓ The interest payments have been estimated on the basis of past loans and future expected borrowings.
- ✓ Subsidy has been pegged in case of power, food and industries. However in case of power subsidy backlog of subsidies will be given based on the resources available.
- ✓ High growth rates in the area of High Priority Developmental Expenditures of Education and Health especially in the case of non-salary expenditure as a part of salary expenditure has been continued and a growth rate of 30% has been provided for education and 20% for health.

4. Deficit and Debt Targets

- ✓ The MTFP 2005-09 projects the consolidated revenue deficit to come down from 0.71 per cent of the GSDP to 1.53 per cent.
- ✓ MTFP projects revenue surplus ranging from 0.31 to 1.36 per cent of GSDP as mandated by the Twelfth Finance Commission.
- ✓ The consolidated fiscal deficit is projected to remain below the 3 per cent mark as mandated by FRBM Act and would stabilise at 2.4 per cent of GSDP.
- ✓ The fiscal deficit is projected to remain within the 3 per cent mark as mandated by the Twelfth Finance Commission and is expected to stabilise at 2.75 per cent of GSDP.

Source: Finance Department 2005

In order to examine the impact of salary expenditure on the proposed fiscal correction targets, we have developed alternative fiscal scenarios based on the parameter values assigned to key fiscal variables by MTFP, 2005-09. The Alternative Scenario I presented in Table 16 shows the fiscal impact of a salary increase at differential rates. Within the Alternative Scenario I, the first case shows the impact of salary hike at implicit growth of salary assumed by MTFP, 2005-09. The growth rate of aggregate salary during 2006-07 to 2007-08 works out to be 5.81 per cent. This growth rate is applied to obtain the future profile of salary expenditure. As in the case of Scenario I, there is no hike in the basic pay, the salary expenditure as a percentage of GSDP declines from 3.7 to 2 per cent during 2005-06 to 2015-16. The revenue surplus increases from 0.51 per cent to 1.47 per cent of GSDP, while the fiscal deficit to GSDP ratio stabilizes at 2.75 per cent from 2008-09. The capital expenditure as a percentage of GSDP shows a significant step up from 3.33 to 4.2 per cent of GSDP by the terminal year of projection. The debt GSDP ratio stabilizes and shows a gradual decline. This can be termed as a no pay revision scenario.

However, with an increase in the basic salary by 10 per cent (Scenario II) and superannuation and retirement allowance by the same rate and by keeping DA and other allowances at the existing level, the total increase in the pension and salary bill works out to be Rs. 893 crores which puts the State into revenue deficit in the base year. With a salary expenditure growth of 5.81 per cent, the profile of salary expenditure grows in such a manner that the State generates revenue surplus in the next year and by the terminal year of projection the revenue surplus works out to be 1.06 per cent. However, in this scenario the fiscal deficit would exceed 3 per cent of GSDP, but will have to be limited to 3 per cent by compressing capital expenditure to conform to the targets specified in the fiscal restructuring plan recommended by the TFC. It may be noted that the according to the restructuring plan, the State government will have to phase out revenue deficits and the fiscal deficit will have to be contained at 3 per cent of GSDP by 2009-10. However, the State government will have to amend the MTFP targets. The fiscal scenario would be worse if the basic pay, superannuation and retirement allowance is increased by 20 per cent, but can still be made consistent with the TFC fiscal restructuring targets (Scenario III).

Table 16: Fiscal Profile of Karnataka: The Alternative Scenario-I

(As a per cent to GSDP)

	2005-06BE	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Scenario I: Implicit Growth of Salary Assumed by MTFP 2006-10											
Revenue Receipts	16.4	17.9	17.8	17.7	17.6	17.5	17.4	17.3	17.3	17.2	17.1
Revenue Expenditure	15.7	17.1	16.8	16.6	16.4	16.1	15.9	15.7	15.5	15.2	15.0
Interest Payment	2.3	2.3	2.4	2.3	2.3	2.3	2.2	2.2	2.2	2.1	2.1
Pension	1.4	1.4	1.4	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Salary Expenditure	3.5	3.8	3.7	3.5	3.4	3.2	3.1	2.9	2.8	2.7	2.6
Capital Expenditure	3.6	3.6	3.8	3.8	4.0	4.1	4.3	4.4	4.5	4.7	4.8
Revenue Deficit	-0.7	-0.8	-1.0	-1.1	-1.2	-1.4	-1.5	-1.6	-1.8	-1.9	-2.1
Fiscal Deficit	2.85	2.79	2.80	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75
Primary Deficit	0.6	0.5	0.4	0.4	0.5	0.5	0.5	0.6	0.6	0.6	0.6
Outstanding Debt	30.7	30.3	29.8	29.3	28.8	28.4	28.1	27.8	27.5	27.2	27.0
Scenario II: Increase in Basic Pay by 10 per cent											
Revenue Receipts	16.4	17.9	17.8	17.7	17.6	17.5	17.4	17.3	17.3	17.2	17.1
Revenue Expenditure	15.7	17.7	17.4	17.1	16.9	16.6	16.4	16.2	15.9	15.7	15.5
Interest Payment	2.3	2.4	2.4	2.4	2.3	2.3	2.3	2.2	2.2	2.2	2.2
Pension	1.4	1.6	1.6	1.6	1.6	1.6	1.6	1.7	1.7	1.7	1.7
Salary Expenditure	3.5	4.2	4.0	3.9	3.7	3.5	3.4	3.2	3.1	2.9	2.8
Capital Expenditure	3.6	3.6	3.8	3.8	4.0	4.1	4.3	4.4	4.5	4.7	4.8
Revenue Deficit	-0.7	-0.2	-0.4	-0.5	-0.7	-0.8	-1.0	-1.2	-1.3	-1.5	-1.6
Fiscal Deficit	2.85	3.37	3.36	3.29	3.28	3.26	3.25	3.24	3.22	3.21	3.20
Primary Deficit	0.6	1.0	0.9	0.9	0.9	1.0	1.0	1.0	1.0	1.0	1.0
Outstanding Debt	30.7	30.9	30.9	30.8	30.7	30.6	30.5	30.4	30.3	30.2	30.1
Scenario III: Increase in Basic Pay by 20 per cent											
Revenue Receipts	16.4	17.9	17.8	17.7	17.6	17.5	17.4	17.3	17.3	17.2	17.1
Revenue Expenditure	15.7	18.2	18.0	17.7	17.4	17.2	16.9	16.6	16.4	16.2	15.9
Interest Payment	2.3	2.4	2.5	2.4	2.4	2.3	2.3	2.3	2.2	2.2	2.2
Pension	1.4	1.7	1.7	1.7	1.8	1.8	1.8	1.8	1.8	1.8	1.9
Salary Expenditure	3.5	4.6	4.4	4.2	4.0	3.9	3.7	3.5	3.4	3.2	3.1
Capital Expenditure	3.6	3.6	3.8	3.8	4.0	4.1	4.3	4.4	4.5	4.7	4.8
Revenue Deficit	-0.7	0.3	0.2	0.0	-0.2	-0.3	-0.5	-0.7	-0.8	-1.0	-1.2
Fiscal Deficit	2.85	3.94	3.92	3.84	3.80	3.77	3.75	3.72	3.69	3.67	3.65
Primary Deficit	0.6	1.5	1.5	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Outstanding Debt	30.7	31.4	31.9	32.3	32.6	32.8	32.9	33.1	33.1	33.2	33.2

It is interesting to note that though a significant scaling down of the growth of salary expenditure is proposed in MTFP 2005-09 (See Box 1), the future path of salary adjustment envisages a much higher growth. As proposed by MTFP 2005-09, basic salary, DA and other allowances are expected to grow at 2 per cent, inflation rate and 1 per cent respectively. The scalewise salary breakup and within that the various components of salary data is used to calculate the aggregate salary expenditure growth based on the targeted growth rates of each component assumed in MTFP. The weighted average rate of growth of salary works out to be 3.45 per cent. Applying this growth rate on the base year with differential hikes in basic pay and superannuation and retirement allowances, the Alternative Scenario II is developed and presented in Table 17. In this case also, though the pay revision in Scenarios II and III create difficulties in conforming to the MTFP targets, it is possible to make even 20 per cent revision and still adhere to the fiscal restructuring plan of the TFC. In all these cases, however, the FRA will have to be amended and MTFP targets will have to be revised.

The point to be noted here is that in both Alternative Scenario I and II, undertaking pay revision and conforming to the fiscal restructuring targets set by the TFC would require compressing the capital expenditure. According to the prevailing MTFP target, in the terminal year capital expenditure increases to 3.7 per cent of GSDP in 2009-10. As mentioned above, pay revision would require amending the targets downward for capital expenditures by about 0.5 percentage points to GSDP in the terminal year of the TFC award. Indeed given the infrastructure bottlenecks in the State and the adverse growth implications of reducing capital expenditure growth, this may not be a preferable option.

If the capital expenditure targets have to be retained and fiscal restructuring target of the TFC has to be conformed, the most feasible option is either to improve the revenue productivity of the tax system, increase non-tax revenues and/or phase out power sector subsidies. The MTFP projection takes reasonably high buoyancy for the tax revenue projections and it is unlikely that in the medium term it would be possible to enhance it further. As regards non-tax revenues, although there is scope for improving the collections and is important for accountability, the volume of revenues it would generate may not be large. The most feasible option seems to be to phase out power sector subsidies. In fact, the State government should present the case to the public that feasibility and extent of pay revision is dependent on the phasing out power subsidies and carry out the necessary reform on that account. It can augment explicit subsidy for rural electrification to some extent to make the reform implementable.

An important unknown factor in the entire exercise is the central transfers. Although the TFC recommendations will be in effect until 2009-10, there are uncertainties regarding the plan grants. Given the emphasis on National Common Minimum Program of the United Progressive Alliance government at the Centre, the grants for State plan purposes and for Central sector and Centrally sponsored schemes may not be reduced in the medium term. More importantly, if the revenue buoyancy of the Central tax revenues seen in the recent past continues, the States' fiscal position will be comfortable. It may be noted that the Central tax revenues have grown at about 19 per cent per year since 2002-03 and continuation of this growth will generate additional fiscal space to the State government. Much of the increase has come about in the direct taxes of the Centre mainly due to strengthening of the information system and with further strengthening of the Tax Information Network, one could expect that the high revenue buoyancy will continue. However, it would be premature to expect this and it would be safe to take that the buoyancy assumed by the TFC.

Table 17: Fiscal Profile of Karnataka: The Alternative Scenario-II

(As a per cent to GSDP)

	2005-06BE	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
Scenario I: MTFP Proposed Targeted Growth of Salary Expenditure											
Revenue Receipts	16.4	17.9	17.8	17.7	17.6	17.5	17.4	17.3	17.3	17.2	17.1
Revenue Expenditure	15.7	17.1	16.8	16.6	16.4	16.1	15.9	15.7	15.5	15.2	15.0
Interest Payment	2.3	2.3	2.4	2.3	2.3	2.3	2.2	2.2	2.2	2.1	2.1
Pension	1.4	1.4	1.4	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Salary Expenditure	3.5	3.8	3.5	3.3	3.0	2.8	2.6	2.4	2.2	2.0	1.8
Capital Expenditure	3.6	3.6	3.8	3.8	4.0	4.1	4.3	4.4	4.5	4.7	4.8
Revenue Deficit	-0.7	-0.8	-1.0	-1.1	-1.2	-1.4	-1.5	-1.6	-1.8	-1.9	-2.1
Fiscal Deficit	2.85	2.79	2.80	2.75	2.75	2.75	2.75	2.75	2.75	2.75	2.75
Primary Deficit	0.6	0.5	0.4	0.4	0.5	0.5	0.5	0.6	0.6	0.6	0.6
Outstanding Debt	30.7	30.3	29.8	29.3	28.8	28.4	28.1	27.8	27.5	27.2	27.0
Scenario II: Increase in Basic Pay by 10 Per cent											
Revenue Receipts	16.4	17.9	17.8	17.7	17.6	17.5	17.4	17.3	17.3	17.2	17.1
Revenue Expenditure	15.7	17.7	17.4	17.1	16.9	16.6	16.3	16.1	15.9	15.6	15.4
Interest Payment	2.3	2.4	2.4	2.4	2.3	2.3	2.3	2.2	2.2	2.2	2.2
Pension	1.4	1.6	1.6	1.6	1.6	1.6	1.6	1.7	1.7	1.7	1.7
Salary Expenditure	3.5	4.2	3.9	3.6	3.3	3.1	2.8	2.6	2.4	2.2	2.0
Capital Expenditure	3.6	3.6	3.8	3.8	4.0	4.1	4.3	4.4	4.5	4.7	4.8
Revenue Deficit	-0.7	-0.2	-0.4	-0.6	-0.7	-0.9	-1.1	-1.2	-1.4	-1.6	-1.7
Fiscal Deficit	2.85	3.37	3.35	3.27	3.24	3.22	3.19	3.17	3.15	3.14	3.12
Primary Deficit	0.6	1.0	0.9	0.9	0.9	0.9	0.9	0.9	1.0	1.0	1.0
Outstanding Debt	30.7	30.9	30.8	30.7	30.6	30.5	30.4	30.2	30.1	29.9	29.8
Scenario III: Increase in Basic Pay by 20 per cent											
Revenue Receipts	16.4	17.9	17.8	17.7	17.6	17.5	17.4	17.3	17.3	17.2	17.1
Revenue Expenditure	15.7	18.2	17.9	17.6	17.3	17.1	16.8	16.5	16.3	16.0	15.8
Interest Payment	2.3	2.4	2.5	2.4	2.4	2.3	2.3	2.3	2.2	2.2	2.2
Pension	1.4	1.7	1.7	1.7	1.8	1.8	1.8	1.8	1.8	1.8	1.9
Salary Expenditure	3.5	4.6	4.3	3.9	3.6	3.3	3.1	2.8	2.6	2.4	2.2
Capital Expenditure	3.6	3.6	3.8	3.8	4.0	4.1	4.3	4.4	4.5	4.7	4.8
Revenue Deficit	-0.7	0.3	0.1	-0.1	-0.2	-0.4	-0.6	-0.8	-1.0	-1.2	-1.3
Fiscal Deficit	2.85	3.94	3.89	3.78	3.73	3.68	3.63	3.59	3.56	3.52	3.49
Primary Deficit	0.6	1.5	1.4	1.4	1.4	1.3	1.3	1.3	1.3	1.3	1.3
Outstanding Debt	30.7	31.4	31.9	32.2	32.4	32.5	32.6	32.7	32.6	32.6	32.5

VII. Conclusions

On the basis of the above analysis, the major findings of the study can be summarized in the following line:

a. The fiscal situation of the State though worsened during the 1990s, there has been a turnaround in recent years. The important reasons for the turnaround are lower interest liability arising from the debt swap, improved buoyancy of State taxes, higher buoyancy of central tax revenues and consequent larger tax devolution and better fiscal management of the States following the fiscal responsibility legislation.

The State is expected to generate a revenue surplus of Rs. 854 crores in the current fiscal years with a fiscal deficit of 2.8 per cent of GSDP.

b. An important cause of fiscal improvement in the State is the higher revenue mobilization, particularly own tax revenues. The own tax revenue buoyancy for the period between 2000-01 and 2005-06 estimated to be 1.548 compared to 0.823 for the period between 1993-94 and 1999-00.

c. The improved fiscal health has provided larger fiscal space in the State. The combined incidence of committed expenditures, viz., interest payment, salary and pension in revenue budget of the State have declined significantly in recent years, but still constitutes around 45 per cent of the total expenditure. An inter-state comparison of incidence of committed expenditures shows that Karnataka's relative position is much better than in other States. However the consolidated public sector deficit of the State still remains a matter of concern, particularly the large power sector subsidy and deficits thereon.

d. The salary expenditure of the State declined from 4.7 to 4.3 per cent of GSDP between 1993-94 and 1998-99 and then increased to 4.8 per cent in the year 1999-00. Thereafter it started declining gradually, particularly due to steady decline in the growth of employment. Currently the salary expenditure constitutes just 3.7 per cent of GSDP, almost 0.6 percentage point lower than that existed before the last pay revision. Thus, the State seems to have completely absorbed the impact of the last pay revision by restructuring employment.

e. The decadal rate of growth of employment in government was the lowest during the nineties at 2.93 per cent compared to 3.55 and 3.57 per cent during the seventies and eighties respectively. Between 2000-01 and 2005-06, yearly growth of employment was negative in all years, except for 2002-03 and 2005-06.

f. The analysis of the structure of employment and scale shows that the government of Karnataka currently has 20 different scales, apart from the all India scales of

IAS/IPS and temporary employees on consolidated pay. The mean basic salary varies from Rs. 3175 in the lowest scale of Group-D to Rs. 16, 840 for highest scale of Group-A employees.

g. The scale wise distribution of employees reveal that it is the Group C that constitutes more than two third of the total employment of the State.

In order to examine the impact of salary revision on fiscal balance, we have developed alternative fiscal scenarios based on various assumptions regarding the future profile of key fiscal variables. The base scenario shows that if the present fiscal profile is projected forward with differential hikes in salary expenditure, States revenue surplus situation gets eroded and fiscal deficit situation worsens depending on the extent of salary increase. The State gets into a revenue deficit situation in the base year itself even with a 10 per cent hike in the basic pay and superannuation and retirement allowances under the base scenario. However, the fiscal parameters can be made consistent with those indicated in the restructuring plan by the TFC. This would require amending the Fiscal Responsibility Act and reworking the MTFP targets to accommodate compression of capital expenditures.

In the case of alternative scenarios, salary induced increase in fiscal imbalance is lower than that in base scenario. However, when pay revision of 10 per cent and 20 per cent are taken account of, the scenarios projected on the basis of MTFP assumptions would not conform to the MTFP targets of revenue and fiscal deficit reductions. The targets will have to be amended to be consistent with those indicated in the fiscal restructuring plan of the TFC. Specifically, the capital expenditure projections forecasted at 3.7 per cent of GSDP in 2009-10, the terminal year of the award of the TFC, will have to be revised lower by about 0.5 percentage points under the assumption of 20 per cent pay revision. Given that the revenue surplus in the year is estimated at 0.2 per cent of GSDP, and as fiscal deficit target according to the TFC targets are 3 per cent of GSDP, the State can incur capital expenditure of 3.2 per cent of GSDP.

From the viewpoint of prudent fiscal management and ensuring allocative and technical efficiency in government expenditure to accelerate growth in the State, it would be inappropriate to compress capital expenditures to adhere to the MTFP targets. Rather, more appropriate option is to phase out the implicit subsidy in the power sector. Power sector subsidy in 2005-06 is estimated at Rs. 1750 crores and the State should take the opportunity and pose the feasibility of pay revision conditional on phasing out power subsidy. .

Our analysis shows that it is feasible for the State government to undertake pay increase even by 20 per cent. This would however, entail reworking of the MTFP targets to compress capital expenditures or alternatively, phase out power sector deficit through rationalisation of power tariff and improved working of the State Electricity Board. In addition to these, if the State government generates additional resources through better revenue mobilization, it could improve outlay on infrastructure spending.

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Information on No. of Sanctioned Posts,Vacant Posts, Working Strenghth, Salary & Grants-in -aid

					(Rs.in crores)		
Year	No. of Sanctioned Posts	No. of Vacant Posts	Sanctioned to Vacant post Ratio	Working Strength	Salary Expenditure	*Grant-in-aid	Salary+ Grant-in-aid
1995-96	589462	84089	14.27	505373	2481	497	2978
1996-97	598037	89083	14.90	508954	2871	596	3467
1997-98	589298	91486	15.52	497812	3365	655	4020
1998-99	619753	93426	15.07	526327	3810	787	4597
1999-00	639331	94893	14.84	544438	4576	915	5491
2000-01	626899	95915	15.30	530984	4630	1136	5766
2001-02	625199	95254	15.24	529945	5030	1074	6104
2002-03	629657	100998	16.04	528659	4941	1069	6010
2003-04	629198	95751	15.22	533447	5323	1022	6345
2004-05	618826	90271	14.59	528555	5392	1122	6514
2005-06(R.E.)	598817	89035	14.87	509782	5932	1246	7178
2006-07(B.E.)	602121	89469	14.86	512652	7186	1352	8538
TGR	0.22	0.31		0.20	8.57	8.42	8.55

*Grant-in aid given to Educational Institutions for payment of Salary, it does not include grants given to Local Bodies as Devolution as per State Finance Commission's Recommendations