Executive Summary

Kerala's is a story of spectacular success in the sphere of social development marred by an indolent industrial growth that has kept the State clamped to the middle rungs of the inter-state income-ladder in India. In terms of per capita Net State Domestic Product (NSDP) at 1980-81 prices, Kerala ranks ninth among the general category states.

The economy of Kerala is critically affected by the substantial remittances sent by a large segment of its population that works abroad or in other parts of India. These remittances impart to the economy, both strengths and weaknesses. While placing extra purchasing power in the hands of the residents, the economy is also subject to volatility and pressure on domestic prices, especially those of land and real estate.

ECONOMY: PRESENT CHALLENGES

The basic economic challenge is that of obtaining a reasonable growth of output and employment on a sustained basis by harnessing the remittance-based flow of resources to the State, and to provide a cushion to the economy against external shocks.

Although Kerala's achievements in the field of health and education have been exemplary, the State is now finding it difficult to maintain the momentum – in particular, the quality of services is deteriorating, and the vast infrastructure of education and health is decaying for want of adequate maintenance.

Kerala has fared better than many other States in bringing down the aggregate poverty-ratio to about 25 percent of population, yet the rural poverty levels are high because of considerable disparities in the distribution of economic activities across regions. There is also a very high degree of unemployment among the educated youth.

While significant achievements in the social sphere were spearheaded by extensive governmental participation, the same strategy did not pay-off in the case of industrial and economic activities. As a result, a large portion of government capital has been locked up in the State Level Public Enterprises (SLPEs) (105 in number), which provide negligible returns.

CONTOURS OF THE FISCAL CRISIS

Kerala is headed for a fiscal crisis, should the present expenditure drives continue, with its outstanding debt to Gross State Domestic Product (GSDP) ratio likely to rise by about 6 percentage points of GSDP in the medium term from its present level of about 35 percent. In particular, a substantial increase in wages and salaries, and a significant rise in the size of the ninth plan outlay, which entitles the State to enlarge its borrowing programme, would lead the economy in this direction. The fiscal deficit to GSDP ratio would be higher than 5 percent in some years.

Although tax revenues have remained buoyant historically, the trade taxes are basically distortionary, and the neighbouring States get the benefit of some of the tax-base of Kerala. Large amount of tax arrears point to the scope of improving tax administration. There are leakages due to low tax rates in the Mahe enclave of the Union Territory of Pondicherry.

Non-tax revenues from the social and economic services have been dismally low; recoveries of loans, given at highly subsidised interest rates are extremely poor and due interest remains largely unrecovered. Not ensuring better recoveries from the social and economic services is suicidal for the services themselves, for neither their infrastructure nor their quality can be maintained without adequate resources.

Contingent liabilities that relate to unviable SLPEs amount to deferred budgetary liabilities. These are now assuming alarming proportions.

There is little flexibility left in managing government finances because of a high degree of rigidity imparted by committed expenditures on account of wages and salaries, pensions, interest payments, and assignments and grants to local bodies. Whereas total revenue receipts are about 20 percent of GSDP, committed expenditure on these heads alone amount to about 14 percent of GSDP.

Government's own contribution to capital formation has depleted significantly. Net capital expenditure has fallen by nearly one percentage point of GSDP between 1985-86 to 1996-97. A large portion of the fiscal deficit is being used to finance the revenue deficit which has been persistent.

FISCAL REFORMS

Two prime objectives should guide the design of fiscal reforms in Kerala, namely, (i) fiscal policy should be conducive to economic growth; and (ii) fiscal balance should be restored at a sustainable level of debt.

Although Kerala experimented with the value added tax in 1993 in a limited way, the State now seems reluctant to pursue this option because of initial difficulties in its implementation. Accounting problems faced by the dealers and the administration and fear of revenue loss led the State to withdraw it after four years, after extending it to 11 commodities. However, as most southern States like Andhra Pradesh, Karnataka and Tamil Nadu are preparing for the implementation of VAT, and Maharashtra has already made significant strides in this direction, Kerala would do well to restore the initiative, this time with proper pre-implementation stage preparation. Otherwise, it will be out-competed in attracting manufacturing and trade activities. In order to prepare for VAT, the following steps are required (i) reduction of the rate categories of sales tax to about 4 (at present there are 18 rates); (ii) training of staff; (iii) computerisation of accounts; and (iv) dissemination of information to the dealers. In order to avoid revenue loss, revenue-neutral rates need to be worked out, and at first, partial rebates on sales tax paid on inputs may also be given.

Since the per capita tax incidence in Kerala is already high, further exploitation of the tax bases via increases in tax rates is not advisable. However, there is scope for garnering additional revenues in the case of stamp duties and registration fees. Since the value of real estate has gone up considerably in recent years, assessment on the basis of fair values would significantly increase revenue from this source. A tightening up of tax administration, backed by a good information-base, would also be revenue yielding, by way of plugging leakages, and recovering tax arrears.

There is a need to further utilise non-tax sources for additional revenue. Many of the fees and user charges have not been revised for long even though costs have been going up. Apart from general services, social and economic services provided for by the government do not need excessive subsidisation except when significant externalities and welfare motives are involved. We have estimated that the recovery rate in the social services was as low as 1.61 percent of costs in 1996-97. For the economic services, it was 4.92 percent. Together, these two sectors draw as much as 13.61 percent of GSDP as subsidy, when implicit and explicit subsidies are considered together. We suggest a graduated approach towards reducing the degree of subsidisation. The sectors that may be targeted first are irrigation, energy, industry and minerals, transport and `other' economic services. On the social side, higher, technical, and medical education as also individualised and curative health services may be targeted.

In so far as expenditure is concerned, two heads where expenditure should increase are non-salary maintenance and capital outlay, especially in the infrastructure sectors. A vast governmental infrastructure is deteriorating for want of adequate maintenance. Relative to other States, Kerala spends more of its budgetary resources on non-Plan and non-developmental heads. This trend ought to be reversed.

Like other States, Kerala would also experience a one-time hike in the wages and salaries bill. We have suggested that no net growth of employment in the government sector should take place in the adjustment period upto the year 2001-02. We have further suggested that subsidies and current transfers should not be allowed to grow in real terms, and in some years they may need to be cut down in real terms.

SECTOR REFORMS

As already indicated, it is difficult to sustain the vast education and health sectors, in terms of quality of services and maintenance of infrastructure. Maintenance expenditure for these sectors needs to be significantly augmented in real terms.

The irrigation sector is languishing for want of resources. The State has fallen significantly short of targets. This sector needs additional investment and attention. The forestry sector contributes a meaningful amount to the exchequer. But, the practice of supplying raw materials at highly subsidised rates should be discontinued.

Kerala State Electricity Board has two problems to attend to: (i) arrange for adequate supply of power; and (ii) show financial viability. For both purposes, it should encourage private sector participation in the generation of electricity. Since, the State government has now provided for automatic periodic increases in the tariff rates, KSEB should be in a position to sort out its financial problems, provided it ensures increase in efficiency on its own part. The Kerala government has recently come out with a policy statement on power sector reforms. While not accepting the possibility of dividing KSEB into three separate units dealing with generation, transmission and distribution and privatising them, the government is in favour of three separate `profit centres' for these activities with separate accounts, although they remain part of KSEB. While partial private sector participation in generation is being allowed, the State government should also look at the possibilities of privatisation in distribution and take into account what some of the other States are doing in this regard. If provision for automatic revision of tariffs for domestic consumers is made, KSEB's financial position would improve significantly.

KSRTC's financial problems are more serious. Its efficiency is low because of the ageing of its bus fleet and overstaffing as also because it may be running (short) uneconomic routes at subsidised fares. Various incentive schemes introduced by KSRTC have not proved to be effective. It should reduce the staff strength in a determined way. An attractive VRS may prove useful. An independent regulatory authority which can also periodically revise fares upwards should be set up.

Nearly 50 percent of the SLPEs have been rendered unviable due to lack of professional management and intrinsic inefficiencies. They need to be gradually weeded out.

Out of the remaining, those that are viable but are not making profits, need to be restructured and revitalised even if it requires additional investment. Where several SLPEs operate in the same area, possibilities of merger should be explored. Sectors like ceramics, cement, chemical and plantation based industries should be considered for this purpose.

FISCAL FUTURE: AN OUTLINE

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

Continuance of present trends, as captured in the base scenario, would imply a deepening fiscal crisis, even while the Plan has to be cut down, while the State experiences a moderate growth rate. Concerted effort at reforming the tax regime would make it more growth - oriented by minimising distortions in productive activities. Further, additional tax and non-tax revenues would ensure that the Plan is largely protected and expenditure is incurred in developmental and high priority expenditures, including maintenance. As larger Plan and development expenditures are incurred, and indigenous economic activities take off with local initiatives, a sustained development impulse would be imparted to the economy.

In order to broadly outline the quantitative impact of the suggested fiscal and sectoral reforms, we may compare the results of the two scenarios. In the base scenario, the outcome of the historic drives of expenditures and revenues indicates that the outstanding debt to GSDP ratio would quickly cross the level of 40 percent and the fiscal deficit to GSDP ratio would be higher than 5 percent of GSDP by 2001-02. The reform scenario which incorporates the fiscal effects of the suggested reforms indicates that it would be possible for the debt to GSDP ratio to come down to a level of 39 percent by 2001-02. We estimate that the main revenue side changes would lead to an increase of 1.83 percent of GSDP on the tax side, and 0.46 percent on the non-tax side by the 2001-02. Wages and salaries would fall by 0.37 percentage points of GSDP and subsidies and current transfers, by 1.07 percentage points by the terminal year. In arriving at these results, we have assumed that the suggested policy changes, which are efficiency augmenting in nature, would be accompanied by an increase in the real GSDP growth of about 1.5 percentage points as compared to the basic scenario.

These two scenarios are intended to serve as benchmarks. We notice that even in the reform scenario, the debt to GSDP ratio is still very high. Reference to this scenario also highlights the risk if there is a slippage from the revenue targets or laxity in expenditure restructuring. In particular, debt to GSDP ratio would cross 40 percent, and the fiscal deficit would be above 5 percent of GSDP. The State should initiate the process of essential adjustment without further delay.