Chapter 1

INTRODUCTION

1.1 The Thirteenth Finance Commission has the unique opportunity to review and draw inferences from nearly six decades of federalism in public finance management of the nation. Based on such inferences, a much needed course correction can be initiated, reversing a trend that has been eroding the very concept of fiscal federalism. Government of Kerala would earnestly plead for such a focus in the work of this Commission.

1.2 Articles of the Constitution between 268 and 275 have designed a well-structured system whereby States get benefit from the Centre's taxation power. The purpose is clear from the wording of Article 275 which is the final residual Article in this structure. Aid to the revenues of States is what the makers of Constitution had in mind. This really gives Finance Commission the authority to deal with the entire area where States' revenues are applied – not just one part like non-plan revenue account expenditure. But Commissions chose to confine themselves to that area (with only one exception in recent times – Second report of the Ninth Finance Commission covering the period 1990-95). Over the years, somehow it came to be accepted that Finance Commissions' main task is to try and balance the non-plan revenue account of States.

1.3 Whenever Commissions chose (or were asked) to look into other aspects, it was either for providing supplementary provisions for developmental expenditure (like special problem grants) or admonish States and guide them out of what was perceived to be their fiscal imprudence. The administration of such condition based grants and debt relief schemes was entrusted with Central Government Ministries.

1.4 All this led to the dilution of Finance Commission's stature as the only body created by the Constitution for assessing Centre's and States' needs comprehensively and evenhandedly. The transformation in its role tended to convert the Finance Commission, in some respects at least, into an extension of the Central Government.

1.5 The terms of reference of the Thirteenth Finance Commission contain a further indication of this. The Commission has been authorised to look into plan expenditure commitments of the Central Government. Even some off budget commitments have been included in the purview of this part of

the terms of reference. The implication is that the quantum of revenue transfer to States should be only out of what is left after Centre meets all such types of expenditure. This seems to convey a subtle hint that the present level of transfer should continue or even be curtailed and that any increase is unacceptable.

1.6 Despite this 'not too States friendly' approach, Government of Kerala feels that this addition to the terms of reference can be converted into an opportunity – an opportunity to restore the Constitutional role of Finance Commission and do equal justice to Centre and States and also among States. That is why we consider that the Thirteenth Finance Commission has a unique opportunity.

1.7 If the Commission is to look into plan expenditure of the Centre, in fairness, similar needs of States should also be looked into. Admittedly it is not practicable for the Commission to asses such requirements of each State. But it is possible to make an overall assessment of the funds needed for at least the present level of plan expenditure and reasonable growth. When that is done for both States and Centre, the result may indicate that the aggregate of all plan and non-plan requirements of States and Centre may add up to a dimension that cannot be handled by total revenue receipts of Centre and States and even a reasonable level of borrowing. There will be the further complication that some States have surpluses which obviously cannot be used by others and so the real total requirement will be even more than the simple aggregate. This means that there is need for optimising total expenditure and a rational approach to assessment of funds to be allocated to States. Whether all the current level commitments are unavoidable, is there a transgression of areas between Centre and States, what would be a fair arrangement for restricting Centre and States to their Constitutional domain, how could States with good track record in improving quality of life be rewarded and encouraged while doing justice to States which have fallen behind etc. are issues which will have to be examined by the Finance Commission.

1.8 The recommendations submitted to the Commission in this memorandum have been designed on this basis. Before proceeding to present them, we would like to trace briefly the evolution of the trend eroding fiscal federalism in the last few decades. We have attempted that in the next chapter. Our idea is to identify the areas, which, in our perception, need intervention and correction by the Finance Commission.

Chapter 2

DECLINE OF FISCAL FEDERALISM

2.1 Allocation of duties and responsibilities between States and Centre is based on a simple principle. Each responsibility is assigned to that level – Centre or State – where it can be discharged more efficiently in public interest. Same is the principle in allocation of revenue raising powers. Each item of taxation is entrusted with that level where it can be more efficiently and optimally levied and collected. Obviously in such an arrangement it is not possible to ensure that the two levels – Centre and States – get exactly the same revenue as is necessary to discharge the responsibilities assigned to them. This apparent mismatch is adequately addressed in the Constitution. Articles 268 and 269 lay down how States can directly get the benefit of some of the taxation powers of the Centre, on a continuing basis. Article 270 (originally Articles 270 and 272) gives the benefit of Centre's taxation to States by passing on to them a prescribed share of the revenues raised. In respect of States which are, even after receiving the benefit of these Articles, in need of further aid to their revenues, Article 275 provides such aid. As there are both a value judgment and a quantum judgment involved in the application of Articles 270 and 275, Constitution provides for a body of eminent experts who will make that judgment every five years. Once it is done, Centre and States can settle to their respective domains and, in full cooperation with each other, adequately finance and efficiently administer their respective levels of governance.

2.2 This excellent structure contained in Articles between 268 and 281, in its pure and undiluted form, ensures that there is no need for States to approach Centre with repeated pleas for funds. Nor would the Centre have the resources to respond to such pleas and condescendingly hand out funds. Only extreme situations like devastation by massive floods, earthquakes etc. would have warranted any other channel of providing help to affected States.

2.3 Almost as soon as this Constitutional order was put in place, deviations started taking shape. With the advent of national planning, a new channel of funding was opened. Whether, in the context of planning, it was necessary to equip the Planning Commission with funds to be given to States was not seriously considered. It was assumed to be necessary. In fact, the Planning Commission would be effective as an expert body which guides States and Centre in articulating development strategies, formulating plans for that and steering both Centre's and States' administrations through the most

important task of executing the plans. In such a situation, handing over funds to that Commission to be distributed among States would have been unnecessary. However such a discussion is now futile as the nation has accepted the arrangement. And, the economy has gained by the work of the Commission, guided by the National Development Council. Therefore, this deviation from the original structure of fiscal federalism need not be subjected to a review at this stage. But that was the first deviation from the original structure of fiscal federalism.

2.4 In the early days of planning, a good part of the funds handled by Planning Commission were given on specified patterns (of grant and loan ratio) for different schemes. This made States eager to pick up schemes which would yield the best ratio for getting funds. Too much intervention by the Planning Commission in execution of schemes also resulted from this. This was recognised and at the time of the Fourth Plan, a new system for financing State Plans was formulated. The Five Year Plan outlay, annual plan outlay and sectoral outlays would be finalised in discussions between States and Planning Commission. For the annual plan so approved, an amount of assistance was fixed based on Gadgil formula. If the States achieved that outlay, full assistance would be available. Within the total outlays, there were priority sector outlays and within such sectoral outlays, earmarked provisions. No diversion for priority sectors was allowed and no reduction in earmarked provisions was allowed. This system ensured the continuance of the wholesome aspects of the earlier system of schematic funding. Unlike the schematic assistance system, the new block assistance system fully accepted States' legitimate right to fix their own priorities, consistent with overall national priorities. It was also decided that schemes of a pilot nature or schemes of inter-state importance should be implemented as Centrally Sponsored Schemes provided for in Central budgets and routed through State Governments who were to be the implementing agencies.

2.5 This arrangement, which supported the concept of federalism, soon gave way to a temptation on the part of Central Ministries to expand their areas of influence. The provision for Centrally Sponsored Schemes steadily grew and the number of such schemes increased. To begin with, the schemes were fully provided for in the Central Budget. Later, a share to be financed by States was included in many of the schemes. That share had to be included in the State's annual plan outlay. As more schemes were taken up and the total requirement grew enormously, States' share also increased. States were however eager to make full use of the Centrally Sponsored Scheme funds, for two reasons. One was the normal trend of trying to get as much as possible from the Centre. The

second was that Centrally Sponsored Scheme assistance was mostly as grant as against the pattern of Central assistance for State Plans. So States tended to squeeze their normal plan scheme provisions to find money to deploy as their share in Centrally Sponsored Schemes. Meanwhile, the component of externally aided schemes in State Plan outlays was also growing. There also a substantial share (roughly 30 percent) had to be found by State Governments within their resources. This put further strain on other schemes in the States' annual plan outlay.

2.6 Gradually, the importance of State Plan outlay and block assistance given under Gadgil formula suffered. With a good part of annual plan outlay predetermined as States' share of Centrally Sponsored Schemes or externally aided projects, States' own priorities had to be accommodated within the residual outlay. System of block assistance under Gadgil formula also lost its pre-eminent position as the main channel of funds to States after Finance Commission transfer. In the Central Budget of 2008-09, Central assistance for State Plans is Rs. 59858 crore. Assistance for Centrally Sponsored and Central sector schemes and direct release under Central plan to State/District level autonomous bodies add up to Rs. 83,303 crore. This may be viewed against the NDC decision at the time of Fourth Plan that assistance through Centrally Sponsored Schemes should not exceed one-sixth of the total Central assistance to States.

2.7 The adverse impact of unreasonable growth in Centrally Sponsored Schemes showed up on the administrative side also. Co-ordination of financial management in State Governments became difficult. Central Ministries established and encouraged direct linkage to implementing departments in States. Soon a situation developed where different departments of State Governments would ask for substantial staff expansion and other facilities on the plea that money was coming from Centre and the staff was for implementing Centrally Sponsored Schemes. State Governments, already facing financial difficulties, could not turn down such pleas. So the co-ordinating departments in States found it difficult to finance the rest of State Plan outlays. They also had to find funds for maintaining the staff after the implementation of the Centrally Sponsored Schemes was completed.

2.8 Often it so happens that the budget expectation of assistance in Centrally Sponsored Schemes does not materialise fully. Many of the conditions attached are evolved on a standardised scale for the entire country. In some cases, some of the conditions may not be relevant to a particular State. In

such instances, implementation suffers and shortfalls in expenditure take place. This is another unsettling factor in States' financial management.

2.9 However the most serious flaw in this trend of enormous growth in Centrally Sponsored Schemes provision (including items directly implemented by agencies below the level of State Governments) is that most of the schemes are in areas which are allocated to States under the Constitution. Why should Centre enter such areas is a question which has not been adequately answered anywhere. There is an unstated impression that unless the Centre directly intervenes with funds and attached conditions, schemes in key areas of economic development coming within the purview of States' responsibilities would not be adequately funded and properly implemented by State Governments.

2.10 This approach seems to be prevalent not only in relation to Centrally Sponsored Schemes, but also in some Finance Commission recommendations. The recent trend has been to tie Article 275 grants to what are assessed by the Commission as special problems. If a State has a special problem to be tackled, it should normally figure in the deployment of funds in their plan budgets. That is the basic purpose of prioritisation of expenditure which is, after all, what planning is about. If a State has substantial surplus in the revenue account with or without devolution, why cannot that be put to use in tackling a special problem which is of high priority to that State? Further, when Finance Commission gives grants for such purpose with conditions, Central Government comes to have a role in implementation which is inconsistent with the division of duties and responsibilities between Centre and States. The obvious answer to the doubts mentioned above is again the unstated impression that without such pressure imposed through conditionality, State Governments would not use the funds properly.

2.11 The trend of viewing State Governments with scepticism has been evident also in another important area of public finance management. The overzealous approach to the issue of revenue account deficit is an instance where a good idea is taken beyond its logical purview. It is necessary to ensure that revenue account expenditure does not increase steeply while receipts do not grow correspondingly. So, eventual elimination of revenue account deficit was taken as one goal of good public finance management. This did not mean that States are mismanaging their finances or that the Centre or the Finance Commission has to intervene and discipline them. In fact if one looks at the

overall position in the last four decades, it will be clear that States have managed their finances without creating any net budget deficit. If a Government can ensure that there is no budget deficit (excess of disbursements over receipts), it will automatically mean efficient control of revenue deficit or even fiscal deficit. So, if deficit reduction is the ultimate goal of public finance management, States cannot be faulted (though this achievement was mostly a result of the enforcement of the overdraft regulation scheme). During this period, in many years, Central Government had budget deficits which were converted into RBI securities. So one can even say that States have done better than Centre in this respect. But mere reduction or elimination of deficit (of any type – budget, revenue, fiscal or primary) is no conclusive evidence of good public finance management. How the deficit is controlled is equally, if not more, important. If a State has substantial revenue account surplus but the Centre has to formulate and directly finance a programme, say, of constructing toilets in schools in that State, their revenue account surplus is hardly a commendable achievement. If another State which ensures relatively better tax administration, but takes up effective schemes in social service sectors involving larger components of revenue account expenditure and ends up with a revenue account deficit, that deficit is not something based on which they should be denied their due share in, say, a debt relief scheme. If a State gets unfairly low share of Central taxes, eliminating revenue account deficit or managing fiscal deficit may be beyond their control. In cases where genuine plan requirements, as assessed jointly by the State Government and Planning Commission, necessitate a high proportion of plan revenue expenditure, that may lead to a revenue deficit even if non-plan revenue deficit is eliminated. The point is that there are various factors, some beyond the control of the State Government, which affect the size of revenue account deficit. Adherence to a 'mantra' of elimination of revenue account deficit shows up inadequate understanding of the complexity of public finance management in a developing economy of over a billion people.

2.12 Similarly, in the context of fiscal deficit reduction, each State has to manage its fiscal situation depending on various factors like its revenue earning capacity, committed items and pattern of expenditure and overall debt position. While there can be no dispute that wasteful expenditure has to be eliminated and unproductive expenditure curtailed, the spending priorities are unique to each State depending upon the regional requirements and policy goals. As such, States should be free to pursue their own self determined fiscal correction path, keeping in view their primary duty of public welfare. Quite contrary to this position, uniform rigid fiscal targets have been imposed on States.

2.13 The ultimate purpose of public finance management, like in any other aspect of administration, is public interest. So controlling revenue account deficit or managing fiscal deficit in a manner detrimental to public interest should not be considered a desirable goal.

2.14 Here again the basic flaw is that States are viewed as errant boys who have to be kept in line applying the classic strategy of 'Sama, Dana, Bheda, Danda'. This is inconsistent with not only federalism but even with the concept of democracy. Functionaries at policy levels of Centre and the States both come from political parties which work at State and Central levels. Governments at both levels are guided by legislative bodies elected through the same democratic process. Laws, rules and procedures are same or similar. Senior administrators who execute Government policies come from the same services and sources. Why should, in spite of all this, States be considered inherently incapable of managing their finances? If the argument is that State Governments, being closer to people, are liable to be influenced by local pressure groups and cannot therefore take decisions in common public interest, the entire basis of our federal structure is being challenged in that assumption.

2.15 The trend of weakening federalism has been evident not only in the vertical relationship of the two levels of governance – Centre and States. In the horizontal distribution of financial resources also this seems to be happening. It arose from a genuine concern for helping weaker States. Successive Finance Commissions have considered this a major goal of revenue transfer from Centre to States. This is in spite of the fact that one of the important aims of planning is regional balance in economic development and that Planning Commission is eminently equipped to handle that aspect through Central and State Plans. The well-intentioned zeal of Finance Commissions in this respect has created a problem for States which have managed their economies relatively better. Huge differences have resulted in the per capita devolution of share of Central taxes to different States. For instance, in the recommendation of the Twelfth Finance Commission, among non-special category States the per capita share (1971 population) of Central taxes for the State which gets the lowest share is Rs. 5861 and the per capita share of the State which gets the highest share is Rs.19864 i.e. nearly 3½ times the lowest. (If special category States are also included, the difference is fantastic, nearly 12 times.) How does the Indian citizen living in the former State deserve such a grossly harsh treatment compared to his brother in the latter State? The role of the Finance Commission is to achieve that degree of subtle

balancing whereby the needs of the weaker States are met without making the others feel let down. This is, no doubt, a difficult task. But failure in achieving it may not be good for the integrity of the nation, in the long run.

2.16 What we have tried to narrate in the preceding paragraphs is the decline of fiscal federalism in the last four decades. This cannot be corrected at one go. But a definite move for correction has to be initiated. The only body which can do so is the Finance Commission. That is the course correction we have mentioned in the very first paragraph of this memorandum.

2.17 That course correction, in the perception of the Government of Kerala, should be on the lines listed below.

- **Primacy of Finance Commission in steering Centre-State financial relations should be reaffirmed.**
- **As Finance Commission transfer is the manifestation of a Constitutional right of States to get a share of Central revenues, it should not be loaded heavily with conditions to be administered by Central Ministries.**
- **Primacy of the State Plan (and Gadgil formula assistance) should be reasserted as the vehicle for developmental efforts. All priority areas and problems special to each State should largely be tackled in the State Plan.**
- **Central plan should not intrude into areas coming within the duties and responsibilities of States under the Constitution. Developmental schemes in such areas should be mostly left to be tackled by State Plans.**
- **To achieve this, the size of State Plans would have to be increased. To enable States to do this, more Central revenue should be given as Gadgil formula grants (Central assistance should have no Central loan component - except back to back external aid).**
- **Revenue transfers and distribution among States should not cause heartburn either to weak or to other States. Both should feel the satisfaction of a fair deal. The range of deviation from average per capita transfer, particularly share of Central taxes, should be rationalised.**
- **The new initiative containing these goals will not cause any substantial deterioration in Centre's revenue account.**

2.18 Our suggestions regarding the matters being considered by the Thirteenth Finance Commission have been formulated on the basis mentioned above. We are presenting our specific proposals for the Commission's consideration in the chapters following the next two chapters which give a factual

account of Kerala Government's fiscal situation and the methodology followed in preparing the forecasts of receipts and expenditure.

Chapter 3

FISCAL SITUATION

3.1 In recent years, there has been a perceptible improvement in the fiscal situation in the country. The consolidated Fiscal deficit of the Centre and the States together which stood at 9.9 percent of GDP in 2001-02 declined steadily to 5.34 percent in 2006-07 and is budgeted at 4.6 percent in 2008-09. The aggregate revenue deficit declined from 7 percent of GDP in 2001-02 to 2 percent in 2006-07 and is budgeted at 0.5 percent in 2008-09. Both Central and State Governments have been able to significantly reduce their fiscal and revenue deficits during this period. The progress in fiscal consolidation has been to the extent that while both Central and State Governments should overreach the fiscal deficit targets set by the Twelfth Finance Commission, the continuing revenue deficit is likely to persist in 2008-09 and even beyond. However, the position in this regard is likely to be impacted by the recent slowing down of the economy and financial crisis.

3.2 The Centre's fiscal deficit as a ratio of GDP declined from 6.2 percent in 2001-02 to 4.5 percent in 2003-04 and is projected to decline to 2.5 percent in 2008-09. Likewise, its revenue deficit relative to GDP registered a decline from 4.4 percent in 2001-02 to 3.6 percent in 2003-04 and is budgeted to further come down to 1 percent in 2008-09. Improvement in fiscal performance of the Central Government has mainly come from higher buoyancy of tax revenue particularly personal and corporate income taxes and service tax. Despite the appreciable fiscal consolidation, large and growing off budget liabilities of the Central Government remain a matter of concern to fiscal stability and sustainability.

3.3 States' finances have also recorded an appreciable improvement in recent years. The aggregate revenue deficit of States which stood at 2.3 percent of GDP in 2003-04 has turned into a marginal surplus of 0.5 percent in 2008-09. The fiscal deficit relative to GDP has improved from the level of 4.4 percent in 2003-04 to 2.1 percent in 2008-09. An analysis reveals that the reduction in revenue deficit achieved by States is largely attributable to increase in revenues and expenditure compression to an extent in some of the States. A significant portion of the increase in revenues has come from higher Central transfers including sizeable non- plan revenue deficit grants given by the Twelfth Finance Commission to some of the States. States' own tax revenue also recorded higher growth mainly on account of Value Added Tax (VAT) reforms and rationalisation of stamp duties

coupled with a boom in the real estate market. The improvement in the expenditure side was mainly due to lower interest payments which was on account of the debt swap scheme of 2004-05, lower volume of borrowings from NSSF and debt restructuring as per the recommendations of the Twelfth Finance Commission.

3.4 Kerala's economy has recorded a buoyant growth in recent years. GSDP in nominal terms has been growing at over 11 percent since 2002-03. The sustained high growth in Kerala has contributed to the increase in real per capita income of the State. This trend of growth in the State's economy is likely to continue in the next few years, despite the recent economic and financial downturn.

3.5 The State of Kerala has been pursuing a fiscal correction path which can lead to fiscal consolidation, stability and sustainability. The State has been able to achieve remarkable improvement in its fiscal performance through better own revenue mobilisation and improved fiscal management, as measured through various fiscal parameters.

3.6 The revenue deficit of Kerala, which was as high as 3.43 percent of GSDP in 2004-05 declined steadily to 1.99 percent of GSDP in 2006-07 i.e., a reduction of 1.44 percentage points in two years. The fiscal deficit also declined from 4.16 percent to 2.88 percent of GSDP during the same period. The primary deficit became surplus in 2006-07. The ratio of revenue deficit to fiscal deficit, which indicates the extent to which current spending is financed by borrowings, also came down to 69.02 percent from 82.41 percent during the same period. It is expected to further come down to 59.85 percent in 2008-09 as against 62.04 percent in 2007-08. The fiscal consolidation process, however, suffered a minor set back in 2007-08 as the revenue deficit grew to the level of 2.55 percent and the fiscal deficit to 4.11 percent (Table 3.1).

Table 3.1 Fiscal Indicators Relative to GSDP (%)

Year	Revenue Deficit	Fiscal Deficit	Primary Deficit
2001-02	3.37	4.22	1.01
2002-03	4.77	5.78	2.37
2003-04	3.83	5.77	2.30
2004-05	3.43	4.16	0.78
2005-06	2.63	3.51	0.32
2006-07	1.99	2.88	(-)0.28

2007-08	2.55	4.11	1.19
2008-09 (BE)	2.04	3.41	0.29

3.7 The fiscal levels in 2007-2008 were largely impacted by coming into effect of the recommendations of the Eighth State Pay Commission for revision of salary and pension, payment of pending Dearness Allowance/Dearness Relief, clearing up of arrears of works already done and increase in developmental spending. If the revenue expenditure in 2006-07 and 2007-08 is adjusted for this huge expenditure, the State would have substantially reduced the Revenue Deficit by March 2008. The State's Budget Estimates for 2008-09 have projected the revenue deficit at the 2006-2007 level of 2 percent of GSDP while the fiscal deficit will be at 3.41 percent of GSDP. The State's Medium Term Fiscal Plan (2008-2009 to 2010-2011) presented to the State Legislature, as required under the Kerala Fiscal Responsibility Act, 2003, along with the Budget Estimates of 2008-09 envisages elimination of revenue deficit and reduction of fiscal deficit to 2.8 percent of GSDP by 2010-11.

3.8 The State has shown significant improvement in its revenue receipts. In recent years, the composition of revenue receipts has been State's Own Tax Revenue (65 percent), Non Tax Revenue (5 percent) and Central transfers (30 percent), though the comparative share of Central transfers to Kerala in 2006-07 was low at 2.5 percent when compared to 6.42 percent of Andhra Pradesh, 4.92 percent of Karnataka and 4.56 percent of Tamil Nadu. As can be seen from Table 3.2 below, the State's Own Tax Revenue as percentage of GSDP (Tax GSDP Ratio) has shown a steady increase, coupled with increased Central transfers.

Table 3.2 Pattern of Revenue Receipts (as percent of GSDP)

Year	State's own Tax Revenue	State's own Non Tax Revenue	Central Transfers	Total Revenue
2001-02	7.7	0.7	3.3	11.7
2002-03	8.5	0.8	3.1	12.33
2003-04	8.4	0.8	3	12.31
2004-05	8.4	0.8	3.5	12.61
2005-06	8.2	0.8	3.8	12.85
2006-07	9	0.7	4	13.70
2007-08	9.2	0.8	4.2	14.21
2008-09 (BE)	9.6	0.8	4.8	15.11

3.9 Increased tax revenue from 2005-06 is mainly attributable to increased sales tax collections achieved through introduction of VAT and higher buoyancy in stamps and registration fee caused by the upswing real estate sector. The average tax GSDP ratio, which is considered a comprehensive indicator of the capacity of the people to pay taxes, has increased to 9.21 percent in 2007-08 compared to 7.65 percent in 2001-02. The Medium Term Fiscal Plan of the State envisages further improvement in the State's Own Tax Revenue to 10.4 percent of GSDP in 2010-11. Also, State's Own Tax Revenue as percentage of its revenue expenditure has improved from 50.79 percent in 2001-02 to 52.21 percent in 2004-05 and to 54.91 percent in 2007-08 and is budgeted at 55.76 percent in 2008-09.

3.10 The State's Non - Tax Revenue constitutes on an average only 5 percent of the State's Own Revenue. The State's Own Non - Tax Revenue relative to GSDP in the last four years (2004 -2005 to 2007-2008) has been of the order of 0.8 percent.

3.11 In this context, it is pertinent to point out that the State's performance on tax effort should be seen against the backdrop of a low primary and secondary sector contribution to the economy and a sizeable tertiary sector (which contributes more than 60 percent to GSDP from 2003-04 onwards) on which the State does not have powers to levy taxes. The composition of GSDP varies from State to State. Further, the income distribution among various segments of the people in the State is such that the scope to raise further tax revenue is limited. Therefore, it may not be fair or realistic to expect Kerala to significantly improve its present level of tax buoyancy.

3.12 It is however hoped that the proposed Goods and Services Tax (GST) should enable Kerala to mobilise more tax revenue from this growing sector of the economy. But this will happen only if the architecture of GST is such that the State's revenue raising capacity and autonomy is appropriately strengthened. In this connection, the framework of GST arrived at by the Empowered Committee of the State Finance Ministers is acceptable to Government of Kerala.

3.13 The State's current focus is nonetheless, to accelerate the pace of industrial growth and infrastructure development. The industrialisation process in the State is being oriented towards small, environment friendly and energy efficient enterprises in areas such as IT, Tourism, Marine products, Biotechnology, Health care etc. Integrated development of physical infrastructure in roads, airports, seaports, power and urban infrastructure is also a priority. The State's policy framework is aimed at

fostering a robust investor friendly and growth oriented environment that would facilitate both private and public – private initiatives, while strengthening the public sector and making it viable through partnerships wherever necessary. In pursuance of this policy, the State has taken a number of measures, which have resulted in some of the Public Sector Undertakings turning around and also private investment flowing into the State in IT and some infrastructure projects. All these initiatives are expected to lead to higher economic growth and attendant tax buoyancy over the medium and long term. This, coupled with the constant efforts being made to streamline tax administration, particularly e-based information system and ensure tax compliance, will enable the State to further improve its tax revenues.

3.14 The growing revenue expenditure is an area of concern in the State's fiscal consolidation process. As percentage of GSDP, revenue expenditure was 15.48 percent in 2005-06 which increased to 15.69 percent in 2006-07 and 16.76 percent in 2007-08 and the same is estimated at 17.15 percent in 2008-09 (BE). The share of non-plan revenue expenditure compared to plan revenue expenditure has also been on the increase. The salary and pension revision implemented by the State following the 8th State Pay Commission recommendations in 2005 had a substantial impact on the State's revenue expenditure in 2006-07 and 2007-08.

3.15 The major components of revenue expenditure are salary, pension and interest payments. The three items together constituted 68.08 percent of the total revenue expenditure in 2007-08. Besides, substantial amounts devolving to Local Self Governments (LSGs) in terms of State Finance Commission's awards are also a significant part of revenue expenditure. However, over the years, the State has been able to significantly contain the growth of expenditure on salary, pension and interest payments. The combined expenditure on these three items accounted for 93.15 percent of the State's total revenue receipts in 2002-03, which came down to 80.29 percent in 2007-08. The budget estimates of 2008-09 envisage this to be further reduced to 75.93 percent. Also, expenditure on account of interest payments has dropped to 20.51 percent of total revenue receipts in 2007-08 compared to 26.8 percent in 2004-05.

3.16 In this context, it is relevant to mention that Kerala has been incurring huge expenditure over the years on social sector comprising education and health. In fact, the State's per capita expenditure in this area is among the highest in the country. If the State has to sustain its achievements in social

sector and human development, adequate funds have to be spent on the much needed maintenance and upgradation of the social assets. Further, given its deep commitment to the concept of welfare State, the State continues to earmark significant outlays towards social security and welfare schemes including pensions, particularly in the informal sector and for disadvantaged senior citizens, women empowerment, subsidy on account of public distribution system including paddy procurement, market intervention operations, etc. The commitment to devolve sufficient funds to Local Self Governments also remains high on the agenda of the State. All this has a major effect on the State's revenue expenditure and the fiscal space available to Government to significantly contain revenue expenditure is very limited.

3.17 The relatively reduced liability towards salary, pension and interest payments has enabled the State to increase its capital expenditure in recent years. The State's capital expenditure which was in the range of less than 1 percent of GSDP till recently had witnessed a substantial rise to the level of 1.6 percent of GSDP in 2007-08. The Budget Estimates of 2008-09 also project capital expenditure at a level of 1.42 percent of GSDP. In the MTFP framework, the capital expenditure is projected to grow to the level of 1.93 percent of GSDP in 2010-11.

3.18 The State has also been able to arrest the growth of its debt liabilities and to peg it at around 37 percent of GSDP since 2006-07. The growth of debt stock during the period from 2001-02 to 2008-09 is shown in Table 3.3 below.

Table 3.3 Growth of debt stock (Rs. crore)

Year	Outstanding debt	Growth percent	Debt as percent of GSDP	Debt as percent of Revenue Receipts
2001-02	26951	12.67	34.83	297.58
2002-03	31063	15.25	36.00	291.99
2003-04	37452	20.58	39.01	316.98
2004-05	41877	11.82	39.12	310.99
2005-06	45929	9.68	38.60	300.30
2006-07	49875	8.59	37.57	274.24
2007-08	55410	11.10	37.32	262.52
2008-09(BE)	61975	11.85	37.56	248.54

3.19 Debt liability is expected to come down to around 35.4 percent of GSDP by 2010-11. The debt liability relative to revenue receipts was above 300 percent till 2005-06. Debt to Revenue ratio has dropped consistently over the last three years and is expected to reach a level of 215 percent by 2010-11. The ratio of interest payments to revenue receipts, another debt sustainability indicator, has also declined steadily. It came down to 20.51 percent in 2007-08 compared to 28.17 percent in 2003-04 and 26.76 percent in 2004-05. It is expected to be at the level of 20.6 percent in 2008-09 and 17.6 percent by 2010-11. The State has also been able to maintain a nominal GSDP growth rate much above the rate of interest paid on debt as shown in Table 3.4.

Table 3.4 Domar Gap

		2004-05	2005-06	2006-07	2007-08	2008-09 BE
(1)	Nominal GSDP growth rate	11.50%	11.16%	11.55%	11.86%	11.10%
(2)	Average cost of Debt	9.11%	8.65%	8.75%	8.22%	8.72%
(3)	Domar Gap (1-2)	2.39	2.51	2.80	3.64	2.38

3.20 When viewed from all these parameters, it is evident that the State has made a remarkable improvement in the area of debt sustainability and this trend is likely to continue in the coming years also. We have made a few suggestions in chapter 8 on Debt for consideration of the Commission to give relief to the State to further improve the debt situation.

3.21 The State has been able to adhere to the ceiling of Rs.14,000 crore on outstanding guarantees set as per the Kerala Ceiling on Government Guarantees Act, 2003. The contingent liabilities on account of guarantees extended by Government have consistently shown downward trends. The total outstanding guarantees which stood at Rs.13,996 crore in 2003-04 have gradually declined over the years to Rs.8,317 crore by the end of March 2008.

3.22 The State remains engaged in pursuing the various fiscal management measures in order to sustain the fiscal improvement that has been achieved. It may, however, be appreciated that the fiscal space available is rather limited given the committed liabilities in terms of expenditure on salary, pension and interest payments as also the continued focus of the State on sustainability of social sector infrastructure, together with the need to further strengthen social security and welfare measures for the marginalised segments of the society, particularly in the wake of the continued

market economy environment. Nevertheless, the State has to move further in the direction of rationalisation of public expenditure wherever possible, additional resource mobilisation and revenue reforms including inter-alia strengthening and streamlining of the tax administration. These steps, coupled with a reasonable level of devolution of funds and revenue account deficit grant (both plan and non-plan) by the Thirteenth Finance Commission, should enable the State to further consolidate the fiscal correction path and achieve the fiscal targets as set in the MTFP, while continuing to step up capital expenditure which, in turn, is expected to lead to higher economic growth and capital formation in the State.

Chapter 4

FORECAST OF RECEIPTS AND EXPENDITURE

4.1 Kerala has always presented the forecasts of revenue and expenditure before the Finance Commissions as realistically as possible. But the successive Finance Commissions, in their reassessments, have overestimated its revenue projections and underestimated the expenditure forecasts with the result that in the recent past the State has not received non-plan revenue deficit grants except a small amount in the first year of the Twelfth Finance Commission period. This is notwithstanding the fact that almost all the projections made by Kerala had always been closer to the actual figures than the Finance Commissions' assessments. In fact, such wide variations between the projections made by the Eleventh and Twelfth Finance Commissions and the actuals are borne out by Tables 4.1 and 4.2.

Table 4.1 11th FC Revenue and Expenditure Projections (Rs. crore)

No.	Particulars	2000-01	2001-02	2002-03	2003-04	2004-05	2000-05
A	**Revenue Receipts**						
1	**Own Tax Revenue**						
	Projection of Government of Kerala	5864.62	6502.89	7259.59	8159.29	9232.86	37019.25
	EFC Projection	6359.98	7428.46	8676.44	10134.08	11836.61	44435.57
	Actual	5870.25	5923.42	7302.54	8088.77	8963.65	36148.63
2	**Own Non tax Revenue**						
	Projection of Government of Kerala	709.55	736.46	793.46	827.46	877.13	3944.06
	EFC Projection	684.78	825.78	984.24	1164.36	1441.08	5100.24
	Actual	659.09	543.38	677.76	806.98	819.08	3506.29
3	**Other Non- plan Grants**						
	Projection of Government of Kerala	13.28	13.28	13.28	13.28	13.28	66.40
	EFC Projection	11.54	12.70	13.97	15.36	16.90	70.47
	Actual	8.52	9.48	12.99	22.38	231.68	285.05
4	**Total Revenue Receipts**						
	Projection of Government of Kerala	6587.45	7252.63	8066.33	9000.03	10123.27	41029.71
	EFC Projection	7056.30	8266.94	9674.65	11313.80	13294.59	49606.28
	Actual	6537.86	6476.28	7993.29	8918.12	10014.42	39939.97
B	**Non-Plan Revenue Expenditure**						
1	**General Services**						
(I)	**Interest Payments** Projection of Government of Kerala	2244.86	2613.22	2942.28	3471.89	4096.83	15369.08
	EFC Projection	1806.74	1987.41	2186.15	2404.77	2645.25	11030.32
	Actual	2257.60	2489.47	2946.76	3328.29	3612.54	14634.66
(ii)	**Pension**						
	Projection of Government of Kerala	1577.69	1893.23	2271.88	2726.26	3271.51	11740.57

	EFC Projection	1460.21	1606.23	1766.85	1943.53	2137.89	8914.71
	Actual	1929.48	1837.93	2282.90	2408.83	2600.77	11059.91
(iii)	**Elections**						
	Projection of Government of Kerala	102.88	17.82	42.30	20.06	21.32	204.38
	EFC Projection	18.80	90.94	23.85	26.36	98.46	258.41
	Actual	33.62	27.50	11.06	20.98	31.84	125.00
(iv)	**Other General Services**						
	Projection of Government of Kerala	945.00	1042.86	1090.36	1166.16	1235.56	5479.94
	EFC Projection	955.57	1006.26	1059.69	1116.01	1175.38	5312.91
	Actual	1229.93	1215.92	1359.21	1493.01	1588.10	6886.17
	Total General Services (I) to (iv)						
	Projection of Government of Kerala *	4870.43	5567.13	6346.82	7384.37	8625.22	32793.97
	EFC Projection	4241.32	4690.84	5036.54	5490.67	6056.98	25516.35
	Actual	5450.63	5570.82	6599.93	7251.11	7833.25	32705.74
2	**Social Services**						
	Projection of Government of Kerala	3070.86	3221.57	3388.24	3566.90	3759.74	17007.31
	EFC Projection	3286.30	3637.76	4034.86	4484.10	4992.93	20435.95
	Actual	3466.80	3416.47	3966.87	4164.08	4776.82	19791.04
3	**Economic Services**						
	Projection of Government of Kerala	1254.35	1354.66	1464.91	1586.17	1715.63	7375.72
	EFC Projection	829.70	888.25	951.62	1020.20	1094.25	4784.02
	Actual	964.94	842.20	1076.95	1612.63	1456.68	5953.40
4	**Compensation and Assignments to Local Bodies**						690.96
	Projection of Government of Kerala	102.48	117.85	135.53	155.86	179.24	
	EFC Projection	62.15	70.23	79.36	89.68	101.33	402.75
	Actual #	55.04	67.00	58.06	73.18	-2.64	250.64
5	**Committed Liabilities**						
	Projection of Government of Kerala			1127.52	1217.72	1315.14	3660.38
	EFC Projection			858.19	944.01	1038.41	2840.61
	Actual - Booked under different heads of account						
6	**Total Non- Plan Revenue Expenditure (I to V)**						
	Projection of Government of Kerala **	9298.12	10261.21	12463.02	13911.02	15594.97	61528.34
	EFC Projection	8419.47	9287.08	10960.57	12028.66	13283.90	53979.68
	Actual	9937.41	9896.49	11701.81	13101.00	14064.11	58700.82
7	**Pre-devolution Non-Plan Revenue Deficit/Surplus**						
	Projection of Government of Kerala **	-2710.67	-3008.58	-4396.69	-4910.99	-5471.70	-20498.63
	EFC Projection	-1363.17	-1020.14	-1285.92	-714.86	10.69	-4373.40
	Actual	-3399.55	-3420.21	-3708.52	-4182.87	-4049.69	-18760.85

Source:- *Finance Accounts, Forecast of Expenditure on Revenue Account 2000-05, Forecast of Revenue Receipts 2000-05, Report of the Eleventh Finance Commission (2000-05)*

* Compensation and Assignments to LBs shown separately

\# Difference between GOK Projection and Actual is due to booking of major share of Local Bodies grant under Plan

** Excluding Fresh Expenditure

Table 4.2 12th FC Revenue and Expenditure Projections (Rs. crore)

No.	Particulars	2005-06	2006-07	2007-08	2008-09 BE	2009-10	2005-10
A	**Revenue Receipts**						
1	**Own Tax Revenue**						
	Projection of Government of Kerala	10226.79	11549.56	13045.73	14738.44	16653.94	66214.46
	TFC Projection	11124.82	12715.67	14534.01	16612.37	18987.94	73974.81
	Actual	9778.62	11941.82	13668.95			
2	**Own Non tax Revenue**						
	Projection of Government of Kerala	916.49	1015.34	1125.93	1249.79	1388.66	5696.22
	TFC Projection	1080.90	1271.84	1486.71	1730.84	2010.76	7581.05
	Actual	936.78	937.57	1209.55			
3	**Total Revenue Receipts**						
	Projection of Government of Kerala	11143.29	12564.90	14171.67	15988.23	18042.60	71910.68
	TFC Projection	12205.72	13987.51	16020.72	18343.21	20998.70	81555.86
	Actual	10715.40	12879.39	14878.50			
B	**Non-Plan Revenue Expenditure**						
1	**General Services**						
(I)	**Interest Payments**						
	Projection of Government of Kerala	4096.10	4677.21	5328.07	5996.34	6702.09	26799.81
	TFC Projection	3814.25	4100.32	4407.84	4738.43	5093.81	22154.65
	Actual	3799.25	4189.70	4329.65			
(ii)	**Pension**						
	Projection of Government of Kerala	2889.58	3135.20	3401.69	3690.83	4004.55	17121.84
	TFC Projection	2817.26	3098.98	3408.88	3749.77	4124.75	17199.64
	Actual	2861.18	3294.58	4924.53			
(iii)	**Elections**						
	Projection of Government of Kerala	40.13	44.12	14.31	15.08	15.90	129.53
	TFC Projection						
	Actual	58.84	37.31	18.50			
(iv)	**Other General Services**						
	Projection of Government of Kerala	1870.70	2049.58	2078.57	2008.59	2057.16	10064.60
	TFC Projection (including Election)	1529.96	1622.13	1685.68	1785.30	1890.76	8513.83
	Actual	1858.93	2057.69	2704.31			
	Total General Services (I) to (iv)						
	Projection of Government of Kerala	8896.51	9906.10	10822.63	11710.84	12779.70	54115.78
	TFC Projection	8161.47	8821.43	9502.40	10273.50	11109.32	47868.12
	Actual	8578.20	9579.28	11976.99			
2	**Social Services**						
	Projection of Government of Kerala	5257.29	5481.53	5679.34	5968.57	6276.67	28663.39
	TFC Projection	5348.92	5866.44	6434.61	7058.44	7743.42	32451.83

	Actual	4765.53	5438.12	6451.32			
3	**Economic Services**						
	Projection of Government of Kerala	2036.89	2257.59	2468.36	2686.31	2938.01	12387.16
	TFC Projection	1512.79	1614.20	1722.95	1839.58	1964.70	8654.22
	Actual	1857.23	1587.43	2086.77			
4	**Compensation and Assignments to Local Bodies**						
	Projection of Government of Kerala	0.00	0.00	0.00	0.00	0.00	0.00
	TFC Projection	89.89	101.13	113.77	127.99	143.99	576.77
	Actual #	0.00	1911.28	2099.26			
5	**Committed Liabilities**						
	Projection of Government of Kerala	0.00	0.00	0.00	0.00	0.00	0.00
	TFC Projection	0.00	0.00	1384.65	1488.49	1600.13	4473.27
	Actual	0.00	0.00	0.00			
6	**Commitment on DA**						
	Projection of Government of Kerala	1088.75	1121.27	1355.15	1600.01	1856.28	7021.46
	EFC Projection						
	Actual						
7	**Commitment on DR**						
	Projection of Government of Kerala	424.37	467.51	598.10	747.51	918.00	3155.49
	EFC Projection						
	Actual						
8	**Fresh Expenditure**						
	Projection of Government of Kerala	54.80	362.65	317.30	213.48	123.15	1071.38
	EFC Projection						
	Actual						
9	**Total Non- Plan Revenue Expenditure (I to V)**						
	Projection of Government of Kerala	17758.61	19596.65	21240.88	22926.71	24891.81	106414.66
	TFC Projection	15113.07	16403.20	19158.38	20788.00	22561.56	94024.21
	Actual	15200.96	18516.11	22614.35			
10	**Pre-devolution Non-Plan Revenue Deficit/Surplus**						
	Projection of Government of Kerala.	-6615.32	-7031.75	-7069.21	-6938.49	-6849.21	-34503.98
	TFC Projection	-2907.35	-2415.69	-3137.66	-2444.79	-1562.86	-12468.35
	Actual	-4485.56	-5636.72	-7735.85			

Source:- *Finance Accounts, Forecast of Expenditure on Revenue Account 2005-10, Forecast of Revenue Receipts 2005-10, Report of the Twelfth Finance Commission (2005-10)*

\# Difference between GOK Projection and Actual is due to booking of Local Bodies grant under Plan

These Tables underline the need to adopt realistic norms for assessing the forecasts of revenue and expenditure. The vast variations between the assessment and the future realisation and consequent strain on the finances of the State Government can be avoided if the Commission makes a realistic assessment of the non-plan revenue account.

4.2 The forecast of revenue has been made taking into account the full potential for revenue growth and the limited areas available to the State for raising resources. This generally conforms to the guidelines issued by the Commission. Variations, wherever seen, between the forecasts submitted to the Planning Commission and the Thirteenth Finance Commission, have been justified in the explanatory notes on the estimates separately submitted to the Commission. In general, the Trend Growth Rate (TGR) for five years from 2002-03 to 2007-08 has been applied for projections of major tax revenue items. The TGR has also included yield from the additional resource mobilisation measures. The periodic eventualities that affect the TGR during the forecast period have also been taken into account and appropriate adjustments made wherever required. The Trend Growth Rates so adjusted have been applied on 2007-08 figures of the Accountant General. Based on the projections in individual items of major tax revenues, State's Own Tax Revenue is assumed to grow at 13 percent annually for the forecast period. In the case of Non-Tax Revenue, growth rate of 10 to 15 percent, depending on the individual items, has been assumed. These realistic projections show total State's Own Revenue Receipts of Rs.1,38,221 crore for the forecast period of 2010-15. Achieving anything more would be virtually impossible, more so in view of the present economic downturn, which is likely to persist.

4.3 Expenditure under each item has been disaggregated as salary and non-salary components for the purpose of arriving at realistic forecasts. The non-salary portion is further segregated into General services, Social services, Economic services and Fresh expenditure.

4.4 A growth rate of 3 percent on salary for 2007-08 is applied for the estimates of 2008-09, 2009-10 and for the forecast period from 2010 to 2015 to provide for annual increments. Since a portion of the arrears in respect of the 2004 Pay and Pension revision was also paid in 2007-08, necessary adjustments have been made while applying the growth rate to 2007-08 for both salary and pension.

Two instalments of DA @ 6 percent (total 12 percent) are reckoned for each year of the forecast period. Actually, this is likely to go up in view of the current inflationary pressures.

4.5 The Eighth State Pay Commission, in respect of 2004 pay revision (with effect from 01-07-2004), submitted its report in February 2006 and the Government Orders implementing the recommendations were issued in March 2006. But due to administrative procedures the impact of this salary and pension revision was fully absorbed only by the end of 2007-08. Kerala does not follow the Central pay scales and allowances. The scales of pay and allowances are relatively on the lower side in the State. Hence, the Central Pay revision is not adopted here as such. Instead, we have been following the pattern of pay and pension revision every five years since 1973.This has become a fact of life and the State has to live with it. The next Pay and Pension revision in the State is due in 2009-10 (with effect from 01-07-2009) but, given the past trend in this regard, its impact will be felt in the State finances only from 2010-11 onwards because of the administrative procedures in implementation. Since Centre has allowed a rather liberal pay and pension revision, the State also will be constrained to compensate its employees with due consideration of the scale of enhancement allowed to the Central Government staff. The Commission may fully provide for the enhanced committed expenditure estimated at Rs. 9603.80 crore during the award period on pay and pension revision due from 1-7-2009. In case the normative formula for assessment does not provide for the same, the State deserves to be fully compensated by way of a special problem grant under Article 275 on this account.

4.6 A growth rate ranging from 10 percent to 15 percent has been assumed in respect of the non-salary components of General, Social and Economic services, depending on each item of expenditure rather than following the flat rate method of projection.

4.7 The forecasts of compensation and assignments to Local Self Governments (LSGs) are based on the recommendations of the Third State Finance Commission. The 73rd and 74th amendments to the Constitution were designed by the Parliament to empower LSGs as a third tier of governance. This required not only delegation of adequate and appropriate powers by State Legislatures to these bodies but also the assured transfer of financial resources to meet their traditional requirements and the new functions entrusted with them. This means that the funds LSGs raise from their own sources will have to be substantially augmented with funds from the State Government. Kerala had been doing this by a

combined system of transfer of some funds and provision of plan outlays to be implemented by LSGs. The Third State Finance Commission brought in a comprehensive new scheme of devolution aimed at ensuring a minimum reasonable level of funds transfer which, once approved by the State Government, will not depend on the discretion of the State Government from year to year. The Commission recommended that in the year 2006-07 an amount of Rs. 2050 crore should be transferred by the State Government to the LSGs as their share of State tax collection. This amount constituted roughly 17 percent of State's Own Tax Revenue of that year. Here the 3rd State Finance Commission was broadly following the same pattern as practised by Central Finance Commissions for vertical transfer of share of Central taxes to State Governments. The amount has to be provided as Compensation and Assignments to Local Bodies through the major head of account 3604 under non-plan.

4.8 However, as the LSGs are yet to attain that level of capacity which would enable them to properly, promptly and fully utilise such a high level of funds, the Commission indicated which proportion of these funds should be spent for their traditional civic functions, for maintenance of assets transferred by the State Government and for developing and expanding those services and institutions.

4.9 Against this background, out of Rs. 2050 crore for the year 2006-07, Rs. 300 crore was to be spent on traditional civic functions, Rs.350 crore for maintenance of assets and Rs.1400 crore for developing and expanding services and institutions. The 3rd State Finance Commission also recommended that if, as a matter of policy, State Government would like the developmental expenditure of LSGs to be higher than what is warranted by the funds made available through the State Finance Commission route, additional provisions could be made depending on availability of State funds. But, in the forecast what has been included is only the minimum reasonable funds transfer as recommended by the State Finance Commission.

4.10 As recommended by the 3rd State Finance Commission, devolution of funds to LSGs is provided by the State Government in the budgets of the relevant years as Compensation and Assignments to Local Bodies under non-plan revenue account under the major head of account 3604. Only the provision for maintenance of road assets has been included in a different head of account 3054.

4.11 For the period up to 2010-11, projections have been made as per the forecast of the 3rd State Finance Commission at the rate of 10 percent growth each year. As the 4th State Finance Commission is likely to recommend devolution of State tax revenues to LSGs at a rate more than the one recommended by the 3rd State Finance Commission, 12.50 percent annual growth rate has been applied for the remaining years (2011-12 to 2014-15) of the forecast period.

4.12 Over the years, Kerala has made huge investments in the area of public health with the result, it has achieved far better health indices than the rest of the country. Indeed, these are comparable even with those in the developed world. Despite its excellent health outcomes, Kerala now faces some major problems in the health care sector - continuing inadequacy of basic health facilities and out of pocket expenditure for the poorer sections who cannot afford to pay, rapidly increasing diseases associated with lifestyle and ageing, prevalence of environmental diseases and higher incidence of mental health problems are a few. Considering the need to ensure sustainability of the achievements made and to face the emerging second generation problems in this sector, a growth rate of 15 percent is assumed under non-salary components for the estimates of 2008-09, 2009-10 and for the forecast period of 2010-15.

4.13 Kerala's achievements in the field of social development and high quality of life are mainly attributed to the educational advancement the State has made over several years. The State is striving hard for maintaining and sustaining the achievements made in the field of education and to cater to the imperative need to improve qualitative aspects of education. There are at present 12,644 Schools in the State out of which 35.57 percent are in government sector and 57.66 percent in private aided sector, 1647 Higher Secondary Schools out of which 729 are Government Schools and 529 are in the private aided sector and 389 Vocational Higher Secondary Schools, of which 261 are in the Government sector and 128 are in the aided sector. Besides, there are 7 Universities in Kerala, out of which 4 Universities are offering various courses and are multi disciplinary. And the other 3 are Kerala Agricultural University, Cochin University of Science and Technology and Sri Sankaracharya University of Sanskrit. The State Government has also recently approved the setting up of a medical university. The State Government provides plan and non-plan grants to Universities, which have proved to be inadequate despite being a major source of revenue for them. Considering the huge requirement of funds for sustaining the achievements already made, and to improve the quality of higher education, a

growth rate of 15 percent is assumed for the estimates of 2008-09, 2009-10 and for the forecast period of 2010-15.

4.14 The pre-devolution revenue deficit projected for 2009-10 is Rs.12,215 crore while that for 2010-11 is Rs.19,426 crore. This wide variation is mainly due to the anticipated State pay revision due in 2009-10 but its impact will be felt in 2010-11, as earlier explained, and the inclusion of maintenance expenditure of rural roads for the first time. Previously, maintenance of rural roads had not been included in the forecast presented to the Twelfth Finance Commission. Out of the total road length of 1,82,836 km. in Kerala, the length of rural roads alone is 1,61,368 km. considering the enormity of road length, the funds that are being released to the LSGs are very meagre and are grossly inadequate to maintain these roads. The requirement of funds to carry out maintenance of PWD roads is Rs.6,798 crore and that for rural roads is Rs.16,182 crore during the award period.

4.15 The major subsidies provided by Government are under Agriculture, Food and Civil Supplies. Supply of rice at subsidised rate, subsidy to Kerala State Civil Supplies Corporation for market intervention operations, compensation to Civil Supplies Corporation for paddy procurement at the Minimum Support Price fixed by the State Government, free supply of electricity to small & marginal farmers, 'punja' dewatering by pump subsidy, subsidy to co-operatives for conducting festival markets, subsidy for creation of infrastructure in private sector and the recently launched subsidised health insurance scheme are the main items of subsidies.

4.16 The State of Kerala has done far better than the rest of the country in ensuring a durable and sustainable social security network. Successive Governments in Kerala have introduced social security and welfare assistance schemes during the past few decades. At present, there exist more than 35 such schemes for which close to 3 percent of the State budget is being spent. In total, nearly 12 lakh elderly persons are receiving financial assistance from the Government, which mainly comprise agriculture workers (5.3 lakh), widows / destitutes (2.8 lakh), old age pensioners (1.4 lakh) etc. Details are given in the explanatory notes on forecasts of revenue and expenditure. If all this is considered, one can state that Kerala has given a practical meaning to the concept of a welfare State. The Commission should take into account the expenditure on subsidies and social security and welfare schemes while reassessing the non-plan revenue account.

4.17 The total Plan Outlay for the Eleventh Five Year Plan (2007-08 to 2011-12) is Rs.40,422 crore, out of which Rs.4,780 crore is from the contribution of Power sector to State Plan, Rs.10,889 crore from contribution of LSGs and remaining Rs.24,753 crore is through State Budget. Out of Rs. 24,753 crore for the State Plan, Rs.12,296 crore is estimated as Plan Revenue expenditure for the period from 2007-08 to 2011-12 by giving an annual growth rate of 20 percent over 2007-08 figures.

4.18 Many of the plan schemes at the expiry of plan period are carried over to the next five year plan and these are to be continued as non-plan schemes. Implementation of such schemes involves huge expenditure liabilities on the part of the States. At present, 30 percent of such expenditures are being allowed as 'committed liability'. Considering the number of schemes being shifted to the next Plan, this is very much on the lower side. In any case, it is not clear as to how this percentage of 30 percent has been arrived at. The Finance Commission may like to revisit this issue and suggest a rational criterion on the basis of which such expenditures should be taken into account while determining the non-plan revenue deficits of States.

4.19 Another related point in the terms of reference of the Thirteenth Finance Commission is that the needs of the States are to be restricted to the non-salary component of maintenance and upkeep of capital assets and the non-wage related expenditure on plan schemes to be completed by March 31, 2010. In this context, it is pertinent to note that in recent years the salary component of plan expenditure has shown considerable increase mainly due to shift in plan expenditure in favour of social sectors like education and health, where the bulk of the expenditure is salary related. Therefore, restricting the committed expenditure on completed plan schemes to only non- salary component is not correct. Hence, the Commission should consider the entire revenue component of the plan for arriving at committed expenditure.

4.20 The consideration of taking into account the expenditure on plan schemes to be completed by March 31, 2010 also needs to be looked at. Fiscal 2011-12 being the terminal year of the 11th Plan, almost all of the ongoing plan schemes will continue till then when the completed schemes may be shifted to Non-plan from the year 2012-13. Therefore, March 31, 2012 should be taken as the cut off period for the purpose of providing funds for maintenance of completed plan schemes.

4.21 The realistic estimates forecast by us bring out the total State's Own Revenue of Rs.1,38,221 crore and the total non-plan revenue expenditure of Rs.2,25,499 crore leaving a pre-devolution non-plan revenue deficit of Rs.87,279 crore during the forecast period of 2010-15. The pre-devolution plan revenue deficit during this period is Rs.29,582 crore. As mentioned in chapter 6 on Grants-in-aid, revenue deficit grant should reckon the deficit on the Plan side also.

4.22 We have made a realistic assessment of all our revenue receipts and revenue expenditure on both non-plan and plan side as per the guidelines issued by the Commission. Wherever necessary, we have given detailed explanatory notes. We hope that the Commission will take due note of our estimates and evolve a transparent and fair criterion and norms to work out revenue deficit grant due to the State. In our perception, such norms must necessarily include full expenditure on salary and pension revision, grants to local bodies, maintenance expenditure for roads, buildings and irrigation, food and agriculture subsidy, the expenditure incurred on social sector such as education and health, and social security and welfare schemes.

Chapter 5

DEVOLUTION OF CENTRAL TAXES

5.1 In chapter 2 of this memorandum, a brief account of the decline of fiscal federalism has been given. The lines on which a course correction should, in our perception, be attempted have also been listed. The first item in that list is the reassertion of the primacy of Finance Commission transfers in the movement of resources from Centre to States. For this, it is necessary to improve the share of Finance Commission transfers. In suggesting an appropriate share, certain basic facts about the respective expenditure requirements as well as resource potential of Centre and States have to be kept in view.

5.2 States' Own Revenues relative to that of Centre have always been considerably lower. But this disparity in relative revenues is not reflected in the expenditure patterns of Centre and States. Please see Tables 5.1 and 5.2 below. The average gross revenue of Centre, including share of Central taxes to States, was 62.48 percent of the combined total revenue receipts of Centre and States for the period from 1999-2000 to 2006-07 whereas that of States, before devolution of taxes and grants, was 37.52 percent. During the same period the expenditure of the States, out of the combined total expenditure, has increased from 56.08 to 58.67 percent while that of Centre has declined from 43.92 to 41.33 percent.

Table 5.1 Relative share of Centre and States in Combined Revenue Receipts (Rs. crore)

Year	Centre @	States #	Total	% Centre	% States
1999-00	224963	132457	357420	62.94	37.06
2000-01	244550	149436	393986	62.07	37.93
2001-02	254834	160378	415212	61.37	38.63
2002-03	288556	178002	466558	61.85	38.15
2003-04	331179	198111	529290	62.57	37.43
2004-05	386151	236669	622820	62.00	38.00
2005-06	442964	260246	703210	62.99	37.01
2006-07	556717	* 312737	869454	64.03	35.97
Average				62.48	37.52

Source: Centre - Union Budget, States-RBI

Note: @ Before devolution of Share of Central Taxes. # States Own Revenue. *RE

Table 5.2 Relative share of Centre and States in Total Expenditure (Rs. crore)					
Year	Centre #	States	Total	% Centre	% States
1999-00	245870	313889	559759	43.92	56.08
2000-01	266947	347198	614145	43.47	56.53
2001-02	295872	377312	673184	43.95	56.05
2002-03	342990	420462	763452	44.93	55.07
2003-04	396793	526023	922816	43.00	57.00
2004-05	418488	566303	984791	42.50	57.50
2005-06	424078	561682	985760	43.02	56.98
2006-07	484551	* 687946	1172497	41.33	58.67
Average				43.26	56.74

Source: Centre: Union Budget, States – RBI

Note # : Excludes FC devolutions, Plan and Non-Plan assistance to States & UTs, * RE

5.3 Gross transfers to States as a proportion of gross receipts of Centre during the early seventies were in the order of 45 percent. This has fallen over the years to just 30 percent in 2007-08. On the Plan side also the share of Gadgil formula based Normal Central Assistance to States, out of the total Central assistance to State Plans, has come down from 85 percent in 1991-92 to about 30 percent in 2008-09 (BE).

5.4 States have submitted a first ever common memorandum to the Thirteenth Finance Commission requesting enhancement of States' share of Central taxes in the divisible pool to 50 percent, instead of the 30.5 percent recommended by the Twelfth Finance Commission. We believe that raising the share of taxes is a far better option than relying more on grants as a means of devolution of resources from Centre to States. It will rectify the vertical imbalance in resource mobilisation to a great extent. The relative share of Centre and States in receipts and expenditure also justifies such a course of action. It will arrest the declining trend in gross Central transfers relative to gross receipts.

5.5 Government of Kerala strongly endorses the suggestion contained in the all States' memorandum. The share of Central taxes to be devolved to States may be increased to the level of 50 percent of the divisible pool. This will be the most effective way to ensure that States' right to get a reasonable share of Central taxes is not indirectly circumvented through other kinds of transfer of resources which can be subject to Centre's discretion.

5.6 If the increase in States' share of Central taxes from 30.5 percent to 50 percent cannot be achieved in one year's time, we suggest that it may be spread over a period of five years, from 2010-

11 to 2014-15. That way, the impact of the increase on Centre's revenue account will not be sudden. Gradual increase over a five year period can be absorbed, with suitable realignment of the different components of transfer to States, consistent with the spirit of fiscal federalism. We will go into details and illustrate this new pattern in chapter 7 'Course Correction'.

Distribution of share of taxes among States

5.7 Certain basic facts have to be kept in view while discussing the manner in which each State's share is to be determined. The first is that States' share of Central taxes is not really any movement of Centre's resources to States. It is actually the tax revenue of States. As pointed out in chapter 2, Centre's taxation powers are not designed for exclusively meeting their expenditure but are based on the fact that Centre can more effectively levy and collect them. So the share of taxes mandatorily going to States is not Centre's revenue at all. This is evident from the fact that as per Article 270, this share does not enter Centre's consolidated fund. It goes into States' consolidated fund. Had it been the revenue of Centre it would have first moved into Centre's consolidated fund and then moved out by Parliament's appropriation as resource transfer to States.

5.8 Another basic fact to be kept in view is that the most important factor influencing cost of governance - both non-developmental and developmental - is population. Normally the cost of governance of a State with a population of 5 crore will be much higher than the cost of governance of a State with a population of 2 or 3 crore.

5.9 The third basic fact is that Indian States vary vastly in the size of their population. The range is between 2 lakh and 838 lakh (1971 census).

5.10 From these basic facts, it is evident that population of a State should be the main consideration in distributing share of Central taxes. It also means that the fairness of any scheme of such distribution is to be judged on the basis of the per capita share of Central taxes going to each State.

5.11 There are however some other factors which influence the cost of governance. Such factors are of two types. The first type is factors antithetical to population. The best example is area. It has to be admitted that area of a thinly populated State adds to cost of governance, though certainly nowhere near the extent to which population size does. The second type are factors which are

deliberately chosen either on the principle of equity or efficiency. No doubt they are also relevant. However in respect of those factors, value of each State has to be adjusted to the size of the population. That is why Finance Commissions have been using the method of scaling to population (vide paragraph 5.40 of the Report of the Tenth Finance Commission). Once that is done, the net value of each State in that factor, which could be different from the value under population factor, will not differ too drastically from population ratio. Unless such scaling is done, bizarre results might ensue.

5.12 In the recent past, Finance Commissions have been using per capita GSDP as a major factor. The weight given is too unreasonable; and we will explain that later. But even if such high weights are considered reasonable, the way it is applied may result in strange outcome. For instance, in the Twelfth Finance Commission Report, among non-special category States, the highest per capita share of taxes has gone to the State which has the lowest population and the highest per capita GSDP. We have not been able to find out how this could take place while applying a weight of 25 percent for population and 50 percent for per capita GSDP. Perhaps while applying the weight for per capita GSDP, no scaling to population was done.

5.13 It is necessary to go into the fairness of the trend of giving high weightage to per capita GSDP. Apart from the fact that the issue of backwardness is essentially addressed through the instrumentality of State annual plans and the Normal Central Assistance, there are mainly two reasons why this should be reviewed. Firstly it is a defective yardstick. It does not capture all relevant elements of backwardness. For instance, the level of unemployment in a State does not seem to reflect in the GSDP, except indirectly and remotely. The level of distribution of income also does not figure whereas that is a clear indication of the performance of a State in handling economic inequity within their population. The second reason is that, this criterion and distribution based on that is not found effective. States which have received higher share in this assessment through successive Finance Commissions have not, necessarily, shown any improvement (in relative terms) in their position (Table 5.3). Obviously improving the economic status of a State or of the weaker sections of the people of that State is not merely a function of money.

Table 5.3 PER CAPITA GSDP (Comparable) (In Rs.)

Non Special Category States	X FC#	XI FC	XII FC		Special Category States	X FC#	XI FC	XII FC
Andhra Pradesh	3455	11366	18869		Arunachal Pradesh	4670	10705	16579
Bihar	2135	5529	6539		Assam	3195	7968	12288
Chatisgarh			13710		Himachal Pradesh	3618	12154	24762
Goa	7364	25076	56599		Jammu & Kashmir	3534	10007	18132
Gujarat	4602	16332	22708		Manipur	3449	8799	17264
Haryana	5284	16927	26256		Meghalaya	3328	9824	16035
Jharkand			11717		Mizoram	4094	12378	21245
Karnataka	3810	2367	20703		Nagaland	3929	12933	20469
Kerala	3532	13091	22824		Sikkim	4846	11109	20929
Madhya Pradesh	299	9589	13340		Tripura	3163	7984	18974
Maharashtra	5369	19098	26994		Uttaranchal			16998
Orissa	2945	7909	11234					
Punjab	6996	18568	28030					
Rajasthan	3092	10377	15059		Source: Respective FC Reports # Net State Domestic Product			
Tamil Nadu	4093	13926	22587					
Uttar Pradesh	2867	7702	10798					
West Bengal	3750	10171	17377					

Efficient and timely management of resources – both financial and physical - is the key. Merely giving more funds to such States without even checking on what effect the previous Commissions' recommendation in this regard yielded, can only lead to misapplication of scarce resources while simultaneously denying funds to States which could put them to better use. So it is not proper to give a high weightage to per capita income factor. However, Government of Kerala does recognise that backwardness should be a factor in the horizontal distribution formula on the ground of equity but, in view of the above reasons, its weightage should be 10 percent with its value scaled to population (1971).

5.14 Fiscal discipline and Tax effort were the other criteria used by recent Finance Commissions. As stated earlier, we are of the view that States should have the flexibility to manage their fiscal situation depending on the policy goals and factors specific to individual States. Hence, fiscal performance as achieved by States due to their own revenue effort and expenditure management needs to be recognised and suitable weightage given in inter-se distribution of Central taxes. The

fiscal self-reliance and improvement index adopted by the Twelfth Finance Commission may be used to assess fiscal performance of States.

5.15 Tax effort is an important factor as it reflects the tax raising capacity and effort of States. But while calculating the share of States on the basis of tax effort both effort and capacity may be assessed. Tax effort may be taken as the ratio of effort relative (ER) to capacity relative (CR) where ER is the ratio of per capita own tax revenue of the State to the average per capita tax revenue of the relevant group of States (general/special) and CR is the ratio of the per capita GSDP of the State to the average per capita GSDP for the relevant group of States. If, however, the Commission decides to continue with the method used by the two previous Commissions, we submit that the practice of weighting the Tax-GSDP ratio with the inverse of per capita income may be done away with. The weight weakens the connection between the tax effort actually made by a State and the criterion values calculated as per the Finance Commission formula. Obviously the weight is given with a view to compensating poorer States with weaker tax bases. But, one has to be clear as to what one wishes to accomplish by bringing in the tax effort criterion into the devolution formula. If it is meant to incentives revenue mobilisation by States, then the incentivise effects of the criterion should not be mitigated by using such weights. Also, when Tax-GSDP ratio is being used for computing tax effort, the case for additional compensation for weaker tax bases is without merit and such overcompensation would defeat the purpose of the criterion in the formula.

5.16 Taking all aspects into consideration, Government of Kerala suggests that the share of Central taxes may be distributed among States based on the following criteria and weights:

Population	70 %
Income distance	10 %
Area (adjusted)	5 %
Tax effort	10 %
Fiscal performance	5 %

5.17 Another major aspect to be dealt with is the range of difference in per capita share of taxes to States. Table 5.4 shows the position of special category States and non-special category States as per Twelfth Finance Commission recommendation. The per capita shares vary from Rs.5,861 to Rs.69,647.

Table 5.4 XII Finance Commission Per Capita shares of Central Taxes (Amount Rs.)

Non Special Category States		Special Category States	
Punjab	5861	Himachal Pradesh	9152
Maharashtra	6084	Uttaranchal	12805
Haryana	6596	Assam	13596
Kerala	7678	Jammu & Kashmir	16178
Tamil Nadu	7901	Tripura	16413
Gujarat	8202	Manipur	20195
Karnataka	9339	Meghalaya	22766
West Bengal	9775	Nagaland	32273
Andhra Pradesh	10377	Arunachal Pradesh	35347
Rajasthan	13341	Mizoram	48884
Madhya Pradesh	13727	Sikkim	69647
Chatisgarh	14039	All S.C. States	15316
Uttar Pradesh	14106	All N.S.C. States	11038
Orissa	14461		
Jharkand	14524	All States	11289
Bihar	16074		
Goa	19864	Source: XII FC Report, Population 1971	

5.18 Even among non-special category States the variation is too huge. The only way to correct this trend is to determine a range for such variation. We strongly recommend that it should be a range of 80 to 120. The per capita (1971 population) share of taxes of the State with the highest per capita share should not be more than 150 percent of the per capita share of the State which gets the lowest per capita share. Necessary adjustments may be done while working out the percentage entitlements of different States. This range may be applied strictly at least among the non-special category States.

5.19 In this context, we would like to point out that in any direct or indirect application of population factor, population based on 1971 census should be taken. This has the sanction of Parliament, as a resolution to apply 1971 population to all transfer of resources to States had been tabled there more than three decades ago. Taking population based on any subsequent census for even indirect application will be contrary to the spirit of that resolution.

5.20 It is also necessary to give an annexure showing how each State's share in Central taxes has been worked out. This is absolutely essential in the interest of transparency in deciding such an issue of great national importance. We are making this point in the light of the experience the State has had with regard to its declining share in the divisible pool. To illustrate this point, the position in the succeeding paragraph is brought to the notice of the Commission.

Table 5.5 Share of Central Taxes		
FC	Period	% share of Kerala
II	1955-60	3.640
III	1960-65	3.550
IV	1965-70	3.590
V	1970-75	3.830
VI	1975-80	3.920
VII	1980-85	3.950
VIII	1985-90	3.760
IX	1990-95	3.729
X	1995-00	3.875
XI	2000-05	3.057
XII	2005-10	2.665

5.21 The allocation for Kerala in the shareable taxes and duties under various Finance Commissions can be seen in Table 5.5. Kerala's share of 2.665 percent of the divisible pool under the Twelfth Finance Commission was the lowest. In our memorandum to the Twelfth Finance Commission we had at length explained the reasons for treating population as the most important parameter in inter-se distribution of the divisible pool. Population was the sole criterion used by the first three Finance Commissions and it remained as the most important parameter till the Seventh Commission, which drastically reduced the weightage for population from 75 percent to 25 percent. Discarding the original objective criterion, the Eleventh Finance Commission gave only 10 percent weight to population. The criteria and weights given by the last three Finance Commissions are shown in Table 5.6. The State had requested the Twelfth Finance Commission to give up the criteria of backwardness and suggested giving 80 percent weight for population (1971), 10 percent for tax effort and 10 percent for commitment to fiscal reforms. When we compare this against the weights given by the Twelfth Finance Commission for the various criteria, it can be seen that the decision of the Twelfth Commission in assigning weights to criteria was in a way beneficial to Kerala vis-à-vis the formula of the Eleventh Commission except for the sole criterion of geographic area. In the Twelfth Finance Commission, population was given 15 percent more weight, backwardness got 12.5 percent less, index of infrastructure was dropped as suggested by us, weight for tax effort was increased by 2.5 percent and that of fiscal discipline remained at 7.5 percent. So going by the changes in the choice of criteria and the weight given to each (particularly for population and backwardness), Kerala's share should have been higher than what its share was in the Eleventh Finance Commission Report. But actually Kerala's share was reduced from 3.057 to 2.665 percent. How exactly this happened is not clear. The absence of any worksheet in the Commission Report indicating the exact calculation of the impact of each criterion as well as the composite percentage for each State makes it difficult for States to feel sure that they have got what is really their due share as per the formula adopted by the Commission. Hence we strongly plead that the Thirteenth Finance Commission should give an annexure to their Report clearly indicating the calculation arriving at the composite percentage for each State.

Table 5.6 Criteria and Weights			
Criteria	Weightage		
	X FC	XI FC	XII FC
Population	20%	10%	25%
Backwardness	60%	62.5%	50%
Geographic Area	5%	7.5%	10%
Index of infrastructure	5%	7.5%	NIL
Tax Effort	10%	5%	7.5%
Fiscal Discipline	NIL	7.5%	7.5%
TOTAL	100 %	100%	100%

Chapter 6

GRANTS-IN-AID TO STATES UNDER ARTICLE 275

6.1 Every item of expenditure of State Governments comes either under non-plan or plan classification in the budget. At the time of preparing the annual Plan outlay, a detailed estimate of resources availability is done by the State Government and the Planning Commission. In that assessment, first all revenue receipts (excluding plan grants) are assessed and then all non-plan revenue account requirements are assessed. The net of this is taken as resource available (positive or negative) under the item 'Balance from Current Revenues'. A similar assessment of the non-plan capital account is also made and a figure arrived as 'Miscellaneous Capital Receipts'. In these assessments, it is expected that all genuine non-plan requirements are provided for adequately. Then other resources are added to arrive at the quantum of plan resources for that year. Simultaneously, developmental requirements within the framework of the five year plan are taken up according to prioritisation. If this process is done thoroughly, there is no need for any non-plan or plan requirement to be financed through tied grants under Article 275.

6.2 In our view, the approach to grants-in-aid under Article 275 should be based on the perception mentioned above. What it can do is (i) to fill the gap in availability of revenue account resource on the non-plan side, after a vigorous but realistic assessment of the State's efforts. The next is (ii) to fill gap, if any, in the revenue account on the plan side at the existing level. As we have stated earlier, there is absolutely no Constitutional or other reason to exclude the gap on plan side to be left unattended to by Finance Commissions.

6.3 Once this exercise is completed, there will be two categories of States. One would have substantial surplus on the revenue account. The other would have either no per capita surplus or only meagre surpluses. They may be given additional grants under Article 275 to augment their revenue account in order to ensure that adequate surplus is available for capital investment. That would meet the stipulation in paragraph 6 (iv) of the terms of reference.

6.4 Such second stage utilisation (after the first stage of filling non-plan and plan revenue account gaps, as rigorously and realistically assessed by the Finance Commission) of grants under Article 275 should be in our view, norm-based. Tied grants under Article 275 should be mainly limited to calamity

relief grants and grants for augmenting State's consolidated fund to give assistance to Local Self Governments.

6.5 It will also be prudent to fix a ceiling for the level of Article 275 grants. This ceiling may be fixed keeping in view the primacy of share of Central taxes as the vehicle for resource transfer to States. It should therefore be only a minor fraction of the amounts transferred as share of Central taxes.

6.6 This method of utilising the grants-in-aid under Article 275 will be fully consistent with and supportive of the federal structure in our public finance management. If however, the Thirteenth Finance Commission chooses to continue with the system of utilising the grants for (i) gap filling and (ii) for special needs as assessed by them, we would present our main proposals on the lines indicated in the following paragraphs.

6.7 The State has its own specific needs arising out of special problems requiring particular attention. We have identified a few of these needs to be brought before the Commission for favourable consideration and assistance. The key areas are upgradation of standards of administration in revenue earning departments viz. commercial taxes, registration, motor vehicles and revenue administration. This is necessary for improving transparency and governance and for raising revenue for the State. Maintenance of forests, inland waterways, coastal zone management, management of ecology, special problems in the sectors of health, education, social welfare and fisheries, strengthening of police, jails and judicial infrastructure, upgradation of agriculture and veterinary services, development of tribes and tribal areas, rehabilitation of beedi workers and application of IT for transparency are some of the other specific problems, apart from deficit areas in local bodies and natural calamity relief. If full expenditure on maintenance of roads, buildings and irrigation and on the anticipated pay and pension revision due in 2009-10 is not reckoned in reassessment of the State's Non-Plan Revenue Expenditure, these may also be considered for grants under Article 275.

6.8 One of the terms of reference of the Thirteenth Finance Commission is to consider the need to manage ecology, environment and climate change consistent with sustainable development. In this context, the management of forests becomes an important priority. States have a predominant role in enlarging and maintaining the forest cover. As per the National Forest Policy of 1988, Forests should not be looked upon as a source of revenue. Forests are a renewable national resource. They are the

national assets to be protected and enhanced for the wellbeing of the people and the nation. All this takes note of the fact that the States which have a large forest area have an opportunity cost in terms of the foregone economic activity and lower tax revenues. Hence, such States need to be compensated for this cost disability borne by them. Therefore, the Commission may consider giving specific purpose grants under Article 275 to incentivise afforestation.

6.9 The extent of forests in Kerala is 29 percent of its geographical area providing a forest cover of 40.13 percent. Concerted steps have been taken to maintain and protect the forests. The total recorded forest area of the State in 2005 was 11,265 sq. km. This has now increased to 11,305 sq. km. These forests are very rich in biodiversity. The State has stopped the clear felling and selection felling of the natural forests from the mid 80s and thereby has been suffering substantial loss of revenue from timber and other forest produce. In order to maintain the biodiversity and the environmental stability of the region, the State is not harnessing the hydel energy to the extent required. For the last two decades, there has been no new construction of any hydel project and the State is spending its revenues to purchase the energy to meet part of its requirement. We have 4000 km of forest roads the maintenance of which is done by the Forest Department itself and therefore not included under the general road maintenance forecasts. The Commission should consider these factors also while providing grant to the State for maintenance of forests.

6.10 Kerala, with its numerous lakes, rivers and backwaters, is one of the few States in India, where waterways can be successfully used for commercial Inland Water Transport. Because of the excessive demand on land due to high density of population, the cost disability factor adversely affects the State's efforts to widen the roads to ease the choking traffic congestion. Development of the inland waterways is the only permanent solution to this problem. This will provide a more economical and environment friendly mode of transport to supplement the road system. By improving the IWT canals a major portion of the bulk cargoes transported through roads is expected to be diverted to the waterways with the present and future pressure on the road network being reduced.

6.11 The coast of Kerala, extending 560 km, is characterised by a narrow longitudinal barrier strip of low lying land, sand-witched between the Arabian Sea and a continuous chain of lagoons and backwaters with connections to sea at several points. Out of the total coastal length of 560 km, the length which is vulnerable to erosion and which requires protection is 478.14 km. The coastal zone has

the maximum concentration of population and is even many times the State average at several places. Maintenance of a long thickly populated coastline inevitably calls for protecting people, mostly belonging to the deprived sections of the society, from the fury of the tidal waves. Also, the State has to safeguard the coastline from the security angle also. Centre too has an obligation to meet at least part of the expenditure on the coastal security. We hope the Commission would extend generous assistance to the State for Coastal Zone Management.

6.12 The State's other priority areas are special problems in the sectors of health, education, social welfare, fisheries and those related to environment and climate change.

6.13 Due to demographic transition (fertility and mortality rates), the ageing scenario calls for special attention. It is estimated that by 2020, 17 percent of Kerala's population will be above 60 years of age. Therefore, the State merits a special grant under Article 275 to address the problems related to geriatrics and ageing population in respect of the disadvantaged segments of the society.

6.14 Kerala being the tropical region of the country and flanked on its east by the Western Ghats, the ecological significance of this region is immense. The physiographic profile of the State provides it a unique environmental character wherein, the high Western Ghat's mountainous catchment provides all the ecological services not only crucial for its coastal region, but for the States of Tamilnadu and Karnataka also. Thus, 44 rivers emanating from the hills, diversity of life forms and tropical climate conditions underscore high productivity potential and the diverse agricultural potential.

6.15 The important concerns of climate change which need to be taken up at local level include reducing carbon footprints in development, bringing in energy efficiency and improving ecological resilience of the natural resources by optimising their productivity. Our proposals in this respect (detailed proposals on climate change and ecology are separately submitted to the Commission) are based on the following issues which are specifically relevant in the management of ecology, environment and climate change:

- **Food insecurity is likely as the frequency of occurrence of floods and droughts is likely to increase. Rise in sea surface temperature and sea level also adversely affects marine food.**
- **The quality of drinking water along the coast may be poor.**
- **Wayanad, Idukki and Kuttanad agro-eco-systems are likely to be threatened due to climate change. Cropping field boundaries along the high ranges are likely to shrink.**

- **Monsoon behaviour may not be normal, leading to hydel power insecurity and available water is likely to deplete. The findings of hydrologists that the intensity of rainfall will be high, resulting in more precipitation in shorter duration with no major variation in the annual quantum of flow, deserves serious consideration as far as Kerala is concerned.**
- **Rich bio-diversity across the Western Ghats appears to be diminishing.**
- **Human health is likely to be at risk.**
- **Sea level rise will have serious consequences for the coastal zones of the State and the country. Some of the major issues arising from sea level rise that need to be tackled are (a) inundation of wetlands and low lying areas, (b) coastal erosion and modification of morphology, (c) weakening of coastal protection structures, (d) increase in salinity of rivers, bays and groundwater tables, (e) increase in storm surges and (f) inundation of land.**
- **The increase of green house gas concentrations in the atmosphere has been accepted as the major driving force for climate change.**

6.16 The detailed proposals in respect of all the special problems requiring grants under Article 275, including those mentioned above, are submitted as a separate document (Volume- 4).

6.17 The high Human Development Index (HDI) achieved by the State is the outcome of heavy investments consistently made in the social sectors from very early days, even before the formation of the State of Kerala. This was done at the expense of much needed investments in agriculture, industry and infrastructure. Even though Kerala model of development has been well recognised and appreciated, the State is now faced with second generation problems like high rate of unemployment of the educated youth, an ever increasing ageing population with the attendant issues of geriatric care, alarming suicide rate, out-migration, inadequate infrastructure etc. Kerala does not have the resources to sustain and enhance the quality and standards of services in sectors like education, health and social welfare. At the same time, Central transfers for these critical areas have been dwindling over the years because when norms are applied uniformly to all States, Kerala is either left out or has to satisfy with a nominal provision on the ground that the State has already achieved the elementary standards/goals set in these areas. In other words, the State feels penalised for its excellent performance in the social sector and the provision of effective social safety net for the weaker sections of the society. This has to be corrected. Hence the importance of providing specific purpose grants to the State as detailed above.

6.18 Issues and proposals relating to grants in respect of Local Self Governments and Calamity Relief are dealt with in separate chapters.

Chapter 7

COURSE CORRECTION

7.1 As pointed out earlier in the memorandum, the mandate of the Thirteenth Finance Commission enables the Commission to correct the declining trend in fiscal federalism, which has been gathering momentum in the last forty years. The suggestions we have made in the matter of share of taxes (chapter 5) and grants-in-aid (chapter 6) are aimed at this. In this chapter we propose to give our suggestions regarding Central assistance for State plans and then tie up all our suggestions to show that they do not imply any substantial deterioration in the revenue account of the Central Government.

7.2 When the system of block assistance was introduced, that assistance based on Gadgil formula was taken as the only (or by far the biggest) assistance for State's annual plan. Soon this position changed. Special assistance, additional assistance etc. entered into the picture. Over the years this trend continued. In the Central budget of the current year, out of the total Central assistance of nearly Rs.60,000 crore, only an amount of Rs.18,000 crore represents normal assistance, presumably distributed as per revised Gadgil formula. It is necessary not only to arrest this trend but also to reverse it.

7.3 Now, only grant portion of Central assistance is an outgo for Central budget. The loan portion is given as share of market borrowing. (In the case of externally aided programmes taken up before the advent of the 'back to back' type of arrangement, some loan component of additional assistance is still available in Central budget, but that is not substantial). Therefore, the purpose of reversing the trend of reducing the role of Normal Central Assistance can be achieved by fixing a minimum limit for block grants distributed solely as per Gadgil formula. That grant should be distributed among all the twenty eight States on the basis of the different criteria and weights for each criterion under the revised Gadgil formula.

7.4 This can be done as part of the revised pattern we have referred to in paragraph 5.6. As we have mentioned there, the new pattern will be a realignment of the different components of transfer of resources from Centre to States. That realignment will have to initiate a reversal of the trend of erosion of fiscal federalism that has been taking place over the last few decades. To make such a

course correction, the revised pattern will have to keep in view the goals we have indicated in paragraph 2.17 of this memorandum.

7.5 In the Central budget of 2008-09, the total transfer to States is equal to a little over 61 percent of the divisible pool of Central taxes (divisible pool taken as roughly 85 percent of gross tax revenue i.e. Rs.5,86,115 crore). The distribution is given in Table 7.1.

Table 7.1 Resource Transfer from Centre to States Budget - Estimates 2008-09	
Item	Percentage to divisible pool of Central Taxes
1. Share of Taxes	30.50
2.Grants under Article 275	5.95
3. Normal Central Assistance part of Central assistance to State Plan	3.14
4. Sub Total (1+2+3)	**39.59**
5.Other Non-Plan grants	1.36
6. Non-NCA part of Central assistance to State Plan	6.17
7.CSS including direct release to autonomous bodies	14.04
8. Sub Total (5+6+7)	**21.57**
9. Grand Total (4+8)	**61.16**
Source: GOI- Budget at a glance, Expenditure Budget Vol.1	
Divisible pool is taken as roughly 85% of Centre's Gross Tax Revenue	

7.6 The course correction that we are suggesting should start with reduction in the share of Centrally Sponsored Schemes and direct releases to autonomous bodies as, now, many of these schemes relate to areas of development which come within the purview of State Governments according to the division of responsibilities between Centre and States. There will have to be a higher emphasis on Gadgil formula grants compared to various types of adhoc Central assistance. This and the increase in States' share of Central taxes will enable States to take in a good part of the expenditure that Centre incurs on Centrally Sponsored Schemes, including direct releases. Correspondingly, share of the latter in Central budget will come down gradually over the five year period 2010 -15. In the year 2014 -15, the transfer of resources may be as in Table 7.2 (calculated as percentage of the divisible

pool of Central tax revenue). This grand total will workout to only 55 percent of gross tax revenues and 49 percent of the total revenue receipts of the Centre.

Table 7.2 Distribution Formula (2014-15)		
Share of Taxes under Article 270	50%	No conditions should apply to this part. (60 % of the divisible pool)
Grants under Article 275	3%	
Block grants distributed solely as per revised Gadgil formula	7%	
Sub Total (i)	60%	
Other non-plan grants	1%	Subject to conditions as per each scheme / programme (5 % of the divisible pool)
Plan grants of non-Gadgil formula type (special, additional, purpose linked etc.)	1.25%	
Grants for Centrally Sponsored Schemes including direct releases to autonomous bodies etc.	2.75%	
Sub Total (ii)	5%	
Grand Total	65%	

7.7 In order to make this transition gradual (so that Central budget can absorb it without much difficulty), we suggest the following spread indicated in Table 7.3 (over the five year period 2010-15) of this realignment of the different components of transfer to States. (All percentages are linked to the divisible pool of Central taxes.)

Table 7.3 Resource Transfer from Centre to States as Percentage of the Divisible Pool

Item	2008-09 Pattern	Revised Pattern				
		2010-11	2011-12	2012-13	2013-14	2014-15
1. Share of Taxes	30.50	40	42	44	47	50
2.Grants under Article 275	5.95	3	3	3	3	3
3. Normal Central Assistance part of Central Assistance to State Plan	3.14	7	7	7	7	7
4. Total (1+2+3)	39.59	50	52	54	57	60
5. Other Non-Plan Grants	1.36	1	1	1	1	1
6. Non-NCA part of Central Assistance to State Plan	6.17	5	4.25	3.5	2	1.25

7.CSS including Direct release to autonomous bodies	14.04	9	7.75	6.5	5	2.75
8. Total (5+6+7)	21.57	15	13	11	8	5
9. Grand Total (4+8)	61.16	65	65	65	65	65
Note: Divisible pool is reckoned as roughly 85 percent of Gross Tax Revenue.						

7.8 In the realignment of transfer of resources as suggested in this chapter, the net increase in the revenue expenditure of the Central Government (from 61.16 percent to 65 percent) will amount to less than 4 percent of the divisible pool. This increase of 3.84 percent of the divisible pool is equal to only 3.26 percent of the gross tax revenues of the Centre. With the sustained economic growth and attendant buoyancy in Central taxes, this increase in percentage terms will not mean any real difficulty for Centre in financing its other commitments in revenue account.

7.9 In the first year (2010-11) there will be a relatively sharp reduction in the provision for other non-plan grants, non-NCA part of Central assistance and Centrally Sponsored Schemes including direct releases. However, in subsequent years, the reduction will not be sizeable. In the past, on various occasions, National Development Council had suggested shift of a good part of Centrally Sponsored Schemes and funds to States. But no serious attempt has been made yet. The studies which led to the National Development Council decisions in this regard from time to time can give guidance in the realignment of Centrally Sponsored Schemes in the first year (2010-11). In subsequent years, there will be no serious difficulty, as Table 7.4 would indicate.

Table 7.4 NP Grants, CSS & Direct Releases from Centre to States as Percentage of Divisible Pool **(Rs. crore)**

Item	2008-09 Pattern				Revised Pattern									
	2008-09		2009-10		2010-11		2011-12		2012-13		2013-14		2014-15	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Other N.P grants	8000	1.36	9200	1.36	7751	1	8914	1	10251	1	11789	1	13557	1
Non-NCA part of Central Assistance to State Plan	36144	6.17	41565	6.17	38757	5	37885	4.25	35879	3.5	23578	2	16946	1.25
CSS & Direct release to autonomous bodies	82313	14.04	94660	14.04	69762	9	69084	7.75	66633	6.5	58944	5	37282	2.75
Total	126457	21.57	145425	21.57	116271	15	115883	13	112763	11	94311	8	67786	5

Note: Divisible pool is reckoned as roughly 85 percent of Gross Tax Revenue. GTR is projected assuming a very low 15% annual growth over 2008-09 B.E. The percentage of growth is not material here as the purpose is showing comparative proportions.

7.10 The distribution of percentages (and amounts) shown in Table 7.4 are indicative. The idea is to illustrate our point that, under the revised pattern suggested, there will be no serious difficulty in providing adequate funds for those three items subject, of course, to the basic idea that Centre should withdraw from Centrally Sponsored Schemes (including direct releases) relating to areas coming within States' powers. However we note the fact that at the time of preparation of Central budgets, the distribution of funds among the three items (other non-plan grants, non-NCA assistance and Centrally Sponsored Schemes) will depend on the requirement for each, as judged by the Centre. When the aggregate for the three items is taken the reduction in the years after 2010-11 will be nominal as the buoyancy will make good the fall in availability of funds.

7.11 To summarise, we suggest that Finance Commission may recommend increase in States' share of Central taxes from 30.5 percent to 50 percent of the divisible pool, spread over each of the five years from 2010-11 to 2014-15 as 40 percent, 42 percent, 44 percent, 47 percent and 50 percent respectively of the divisible pool. The Commission may also fix a cap of 65 percent of the divisible pool of each year, for the total transfer of (non-loan) resources from Centre to States, as indicated in Table 7.3.

7.12 In this context, we would suggest that Finance Commission should also review the calculation for arriving at the divisible pool from the gross tax revenue in the Central budget. Going by the figures of gross tax revenue and States' share as given in the Central budget 2008-09, the divisible pool is roughly 85 percent of gross tax revenue. This difference between gross tax receipts and the divisible pool does not, prima-facie appear reasonable. That is why we suggest that the Finance Commission may review the calculation so that States do not lose revenue on account of any flaw in the method of arriving at the amount in the divisible pool.

7.13 We also suggest that the Commission may recommend that every year Finance Ministry should prepare a detailed statement of the amount given to each State under each of the categories and present it in the National Development Council meeting. It will be helpful if that statement would also be discussed in Parliament so that Members of Parliament would get a clear idea about the allocation to different States.

7.14 Instead of indicating a cap on resources transferred to States on the basis of past actuals, the system suggested in this chapter (linkage to the divisible pool as percentage) will be better. That will be much more transparent and can be operationalised while preparing the Central budget for each year.

7.15 Above all, this system will initiate the much delayed process of course correction, which is the main theme of this memorandum. If that happens, the recommendations of the Thirteenth Finance Commission will mark the beginning of a new era in the Centre-State financial relations and will alter positively its course.

Chapter 8

DEBT POSITION - CORRECTIVE MEASURES

8.1 Debt is the accumulated borrowings to finance fiscal deficits over the years. Rising debt levels and the attendant interest payments reduce ability of States to open up fiscal space required for enhancing outlays on essential services. States with manageable debt stock will, on the other hand, be able to maintain budgetary control and balance, and also attract more private investment to accelerate and sustain economic growth. Thus, efficient management of debt constitutes an integral part of fiscal discipline.

8.2 The debt profile of Kerala (Table 8.1) shows the composition of debt for the last five years. The Open Market Borrowings (OMB) now constitutes nearly 30 percent of our total borrowings while the share of small savings is close to 29 percent. The securities issued to the National Small Savings Fund (NSSF) also come to 21.62 percent as at the end of 2008 though its share will increasingly decline in the future due to negative net NSS collections, which will lead to a corresponding increase in OMBs. The change in Central policy of withdrawing loan component from the plan assistance extended to States, on the recommendation of the Twelfth Finance Commission, has naturally resulted in the decline of the share of Central loans to just under 10 percent.

Table 8.1 Debt Profile of Kerala

	Outstanding as on 31.03.2004		Outstanding as on 31.03.2005		Outstanding as on 31.03.2006		Outstanding as on 31.03.2007		Outstanding as on 31.03.2008	
	Amt. Rs cr	% Share	Amt. Rs cr	% Share	Amt. Rs cr	% Share	Amt. Rs cr	% Share	Amt. Rs cr	% Share
1. Internal Debt	17420.94	46.52	21676.22	51.76	25670.72	55.89	29969.15	60.09	34019.16	61.40
(a) Special Securities issued to NSSF	4253.35	11.36	7048.30	16.83	9697.75	21.11	11875.28	23.81	11982.02	21.62
(b) Negotiated Loan	2946.61	7.87	3370.37	8.05	3504.54	7.63	3966.12	7.95	4401.53	7.94
(i) Loans from LIC	1944.09	5.19	2282.26	5.45	2591.10	5.64	2870.69	5.76	3135.71	5.66
(ii) Loans from GIC/ Subsidiaries	247.69	0.66	273.93	0.65	298.64	0.65	321.87	0.65	323.61	0.58
(iii) Loans from NABARD	479.37	1.28	524.62	1.25	341.15	0.74	552.03	1.11	691.15	1.25
(iv) Loans from NCDC	275.46	0.74	289.56	0.69	273.65	0.60	221.53	0.44	251.05	0.45
(c) Open Market Borrowings	8229.30	21.97	9605.69	22.94	11062.00	24.08	12847.33	25.76	16481.17	29.74

(d) Others	1991.68	5.32	1651.86	3.94	1406.43	3.06	1280.42	2.57	1154.46	2.08
2. Loans from GOI	5627.97	15.03	5410.83	12.92	5417.40	11.80	5371.77	10.77	5532.63	9.98
Of which Share of NSS collection	323.09	0.86	150.95	0.36	0.00	0.00	0.00	0.00	0.00	0.00
3. Small Savings	14403.33	38.46	14790.82	35.32	14840.93	32.31	14534.26	29.14	15857.77	28.62
(a) Loans from PF	4904.98	13.10	5498.08	13.13	6104.98	13.29	6778.36	13.59	7904.85	14.27
(b) Treasury SB	8776.26	23.43	8438.91	20.15	7713.94	16.80	6554.54	13.14	6535.63	11.80
(c) Trust, Insurance etc.	722.09	1.93	853.83	2.04	1022.01	2.23	1201.36	2.41	1417.30	2.56
TOTAL	37452.24	100.00	41877.87	100.00	45929.05	100.00	49875.18	100.00	55409.57	100.00

8.3 Despite improvement in revenue of the State, the present aggregate debt stock remains rather high. This is because the State, apart from huge expenditure on pay and pension, is committed to spend more on social sectors and social security and welfare schemes meant for the poor and marginalised sections of the society. Also, the Finance Commission transfer to Kerala, in terms of its relative share in horizontal devolution, has been coming down sharply with the result that the State is constrained to depend more and more on borrowings to keep these commitments. However, due to conscious efforts made by the State, debt sustainability indicators have shown improvement in the last few years.

8.4 Kerala was also one of the first States to enact legislation to cap government guarantees in order to contain contingent liabilities. The statutory limit fixed by the Legislature in 2003 was the absolute amount of Rs.14,000 crore. The State has made conscious efforts to contain the liabilities within this limit. In 2003-04 the total outstanding guarantees stood at Rs.13,996 crore but by the end of 2006-07 it was gradually reduced to Rs.9496 crore and to Rs.8317 crore in 2007-08.

8.5 Table 8.2 shows that the annual growth rate of debt has declined from 20.58 percent in 2003-04 to 11.10 percent in 2007-08. State has been able to improve debt-revenue ratio from 317 percent in 2003-04 to just 263 percent in 2007- 08. The debt/GSDP ratio has been declining and is presently at 37 percent. The ratio of interest payments to revenue receipts has shown a consistent improvement with 20.51 percent level in 2007-08. The average rate of interest also remains lower than the GSDP growth rate from 2002-03 onwards. However, the overall debt liability of the State has to be further

reduced to below 30 percent of GSDP for which the State needs further relief from the Finance Commission.

Table 8.2 Fiscal Indicators of Debt Sustainability - Kerala (Rs. crore)

Indicators	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
R.D./G.S.D.P (%)	5.27	4.36	3.37	4.77	3.83	3.43	2.63	1.99	2.55
F.D./G.S.D.P (%)	6.60	5.38	4.22	5.78	5.77	4.16	3.51	2.88	4.11
R.D./F.D. (%)	79.87	81.16	79.70	82.54	66.44	82.41	74.83	69.02	62.04
Debt outstanding /G.S.D.P. (%)	29.40	33.15	34.83	36.00	39.01	39.12	38.60	37.57	37.32
Debt outstanding /T.R.R. (%)	253.98	273.96	297.58	291.99	316.98	310.19	300.30	274.24	262.52
Interest/T.R.R. (%)	24.58	25.86	27.49	27.70	28.17	26.76	24.84	23.04	20.51
R.D./T.R.R. (%)	45.56	36.05	28.77	38.72	31.15	27.18	20.46	14.50	17.93
Growth rate of Debt (%)		18.55	12.67	15.25	20.58	11.82	9.68	8.59	11.10
Primary Revenue Surplus/Deficit	-1666.89	-889.45	-116.17	-1171.89	-352.01	-56.38	670.10	1551.75	544.80
Primary Fiscal Deficit/ Surplus.	-2579.29	-1620.20	-779.94	-2043.27	-2210.76	-839.36	-382.45	367.82	-1770.56
Average Rates of Interest (%)	10.88	10.24	9.79	10.16	9.72	9.11	8.65	8.75	8.22
G.S.D.P.	68617.02	72143.42	77385.36	86275.16	96012.06	107053.67	118998.19	132738.53	148485.00
Growth rate of G.S.D.P. (%)		5.14	7.27	11.49	11.29	11.50	11.16	11.55	11.86

Source: Finance Accounts, Kerala budget documents

8.6 Previous Finance Commissions have recommended various measures to reduce the debt burden of States but relief to States on this account has not been significant. The outstanding debt of all States which stood at Rs.1,28,155 crore in 1991 had risen to Rs.13,78,663 crore at the end of March, 2008. The total outstanding Central loans to all States during the same period went up from Rs.73,521 crore to Rs.1,65,502 crore.

8.7 The Twelfth Finance Commission suggested discontinuation of the Fiscal Reform Facility recommended by the previous Commission as it failed to provide adequate relief to States. The Commission felt that incentives for fiscal performance should be built into the debt write-off package and therefore recommended the introduction of a debt write-off scheme linked to the reduction of revenue deficit of States. The Debt Consolidation and Relief Facility (DCRF) consist of (a) a general scheme of debt relief through debt consolidation and re-schedulement and (b) a debt write-off scheme

based on fiscal performance. The general scheme of debt consolidation is applicable to all States that enact Fiscal Responsibility Legislation (FRL) with prescribed clauses, inter alia, to eliminate revenue deficit by 2008-09 and to reduce fiscal deficit to 3 percent of GSDP by 2008-09 whereas the debt write-off scheme is linked to the absolute amount by which revenue deficit is reduced, in each successive year during the award period, from the base level compiled by the Commission. Consequently, the total amount of loans of all eligible States thus consolidated stands at Rs.1,09,977 crore and the benefit of debt waiver for all States together, as of 31-03-2008, is a mere Rs.13,285 crore only (i.e. 8.03 percent of the total outstanding debt to Centre).

8.8 These clauses prescribed in the FRL are applicable across all States alike regardless of their initial levels of revenue and fiscal deficits and debt GSDP levels. This is not a correct approach. This not only strikes at the root of fiscal autonomy and space available with States, divergent situations in States in terms of fiscal capacity differentials, patterns of expenditure and development priorities are not amenable to uniform fiscal reduction targets. The basic fiscal principle that different States can have different levels of sustainable fiscal and revenue deficits needs to be recognised. Even the Central government has not been able to adhere to their FRBM targets. Thus, 'one size fits all' approach is neither desirable nor rational. Hence, it is not fair and reasonable to bind States to rigid fiscal targets and make the benefit of debt consolidation and waiver contingent on achieving such targets. Accordingly, States should be allowed to pursue their own fiscal correction strategy to manage fiscal situation without prejudice to the imperative need for continued growth and socio economic development.

8.9 So long as fiscal deficit is kept within manageable limits and the borrowed funds are utilised for capital investments, States' share in Open Market Borrowings can be enhanced appropriately, though subject to prudent levels of sustainable debt. At present, States' share of OMBs comes to only about 20 percent while Centre retains the other 80 percent. Since this is often the cheapest source of funds, States' share may be fixed at 33.33 percent in 2010-11 which may be steadily increased to 50 percent by 2014-15. In the case of fiscally weak States facing difficulty in raising loans from the open market, Centre can extend assistance through loans with interest aligned to the market loans. This is necessary to enable States to spend and raise capital expenditure.

8.10 In paragraph 2.17 of this memorandum we have, as part of the course correction, suggested that Central assistance to States should not have any loan component except back to back external aid. The new pattern of Central transfers proposed in Chapter 7 also does not envisage any loan component. But if the Commission decides to continue with the existing pattern, we request that the following suggestion on Central assistance may be considered favourably.

8.11 The prevailing grant-loan ratio of 30:70 in the Central assistance to State plan schemes was fixed long ago when the revenue component of plan schemes was 30 percent. But now the proportion of revenue relative to capital in plan expenditure of both Centre and States has increased considerably. Table 8.3 shows the present composition of plan expenditure of all States.

Table 8.3 Revenue component of plan expenditure - All States (Rs. crore)

Plan Expenditure	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	Average
Revenue Account	38308	41809	46715	47842	51349	60987	69626	
Capital Account	32012	36806	33424	40761	51326	58825	74967	
Total	70320	78615	80139	88603	102675	119812	144593	
Rev /Plan Expenditure (%)	54.48	53.18	58.29	54.00	50.01	50.90	48.15	52.72

Source: State Finances- A study of budgets, RBI (various issues)

8.12 The average revenue component of the plan expenditure of all States from 1999-00 to 2005-06 is more than 52 percent. In Central plan expenditure, the revenue component has gone up from 61.43 percent in 1999-00 to 83.84 percent in 2005-06. Hence, it is high time that the ratio is refixed. It may be recalled, the Twelfth Finance Commission recommended that in future the Central Government should not act as an intermediary for raising loans for the States in respect of the loan component of the Central plan assistance to States but instead should allow them to approach the market directly. The Thirteenth Finance Commission may take the next logical step and recommend enhancing the grant portion of Normal Central Assistance from 30 percent to 50 percent which will also help States to reduce the debt burden to that extent.

8.13 As stated earlier, the Twelfth Finance Commission had recommended a general scheme of debt relief through debt consolidation and reschedulement. While this is a useful initiative taken by the Commission and has helped many States to improve their debt position, some of the States continue to

have huge negative borrowings in terms of net receipts from Centre mainly due to past Central loans and accumulated interest thereon.

8.14 The Central loans are now a relic of the past as Centre no longer gives loans to States as recommended by the Finance Commission. In fact, States have over the years already made repayments of principal and interest to Centre far in excess of what they have borrowed. Kerala's position on net receipts on account of the borrowings from Centre had turned negative from as early as 2000-01 onwards. It is evident from Table 8.4.

Table 8.4 KERALA- Loans from Central Government (Rs. crore)

Year	Gross Receipts	Repayments	Interest paid	Total payment to Centre (3+4)	Net Receipt from Centre (2-5)
(1)	(2)	(3)	(4)	(5)	(6)
1999-00	1072.97	246.95	703.77	950.72	122.25
2000-01	483.11	284.01	732.27	1016.28	-533.17
2001-02	780.70	536.12	778.56	1314.68	-533.98
2002-03	1192.86	1004.44	805.02	1809.46	-616.60
2003-04	968.17	1875.09	809.92	2685.01	-1716.84
2004-05	1482.11	1699.25	671.60	2370.85	-888.74
2005-06	603.29	596.71	436.44	1033.15	-429.86
2006-07	205.01	250.64	432.73	683.37	-478.36
2007-08	416.43	255.57	429.48	724.04	-307.61
TOTAL	7204.65	6748.78	5799.79	12587.56	-5382.91

8.15 Therefore, the Commission may take the next logical step to recommend waiver of all past Central loans and interest thereon. If this is not possible, at least 50 percent of this liability should be waived. This will help States with high debt stock to further improve their debt position.

8.16 NSSF loan is another area the Commission should look at. In the debt consolidation recommended by the Twelfth Finance Commission, NSSF liabilities were not included, technically these not being Central loans. In this context, it may be noted that States have pointed out earlier that the funds they receive are out of the net NSS collections and not the gross collections. Repayments and payments of interest to the depositors are taken care of by fresh deposits to the NSS Fund and the process goes on perpetually. Taking note of this, the 7th Finance Commission did

recommend consolidation of small savings loan outstanding against each State at the end of 1978-79 and treating this as loan in perpetuity. However, this was not carried through subsequently. It is in this context that the Thirteenth Finance Commission may consider this issue and provide some relief to States. We are of the view that such relief, if not in terms of complete waiver of past loans, could be allowed in the form of alignment of rates of interest on the loans, including the past loans, with the rates of interest being given to the investors after adjusting for cost of collection. This is particularly necessary for those States which have to pay considerable amounts of repayments to NSSF whereas receipts to them from the Fund are minimal. Table 8.5 indicates that Kerala will be required to repay to NSSF an amount in the range of Rs.1400 – 1500 crore each year during the award period but no receipts from the Fund will accrue to it during this period.

Table 8.5 KERALA - Loans from NSSF (Rs. crore)

Year	Amount received from NSSF	Amount repaid to NSSF	Interest Paid to NSSF	Total payment to NSSF (3+4)	Net amount received by State (2-5)
(1)	(2)	(3)	(4)	(5)	(6)
1999-00	571.37			0.00	571.37
2000-01	440.15		56.82	56.82	383.33
2001-02	462.56		143.28	143.28	319.28
2002-03	832.31		192.22	192.22	640.09
2003-04	1946.96		263.32	263.32	1683.64
2004-05	2794.95		455.39	455.39	2339.56
2005-06	2678.02	28.57	720.91	749.48	1928.54
2006-07	2228.10	50.58	971.46	1022.04	1206.06
2007-08	180.45	73.70	1164.60	1238.30	-1057.85
2008-09	0.00	115.32	1151.50	1266.82	-1266.82
2009-10	0.00	212.67	1139.81	1352.48	-1352.48
2010-11	0.00	352.42	1118.87	1471.29	-1471.29
2011-12	0.00	486.32	1084.65	1570.97	-1570.97
2012-13	0.00	597.72	1037.72	1635.44	-1635.44
2013-14	0.00	606.74	980.20	1586.94	-1586.94
2014-15	0.00	606.74	921.82	1528.56	-1528.56

Note : From 2008-09 onwards estimates/forecasts are based on the assumption that no amounts are likely to be received from NSSF due to negative NSS Collection

8.17 The State Government therefore strongly urges that the Commission may look into these aspects while reviewing the working of the DCRF as required by the terms of reference and suggest corrective measures, as was done by the previous Commission, to enable States to maintain a sustainable debt profile.

Chapter 9

STRENGTHENING OF LOCAL SELF GOVERNMENTS

9.1 Local Self Governments (LSGs) are closer to the people and work in a context of face-to-face democracy. This confers on them a lot of advantages like proper delineation of people's priorities, greater congruence between needs and expenditure, better public participation in development, exploitation of local production possibilities, use of cost effective and locally suitable technologies, proper maintenance of assets, mobilisation of contribution from public in terms of manpower and materials, greater transparency, accountability etc.

9.2 Strengthening of LSGs is essential to tap their full potential to achieve effective and efficient governance especially in delivering minimum needs, public services and reduction of poverty. Apart from transfer of mandated functions and functionaries, adequate funds have to devolve to local bodies commensurate with their responsibilities as a third tier of governance. States are under an obligation to do so in the light of the 73rd and 74th amendments to the Constitution.

Approach of the Central Finance Commissions

9.3 Even though Article 280 was amended after the Tenth Finance Commission was set up, it considered the amended Article and took the following two approaches which have tended to influence the later Finance Commissions.

(i) Decentralisation is fiscally neutral and does not entail any extra financial burden on States.

(ii) There is no need to transfer resources from Centre to States in view of decentralisation.

9.4 However, a grant at the rate of Rs.100 per capita of rural population as per 1971 census was recommended. Further, it debarred the use of this amount for salaries and wages and directed States to prepare detailed guidelines for their utilisation. The Eleventh Finance Commission dwelt on measures which States could adopt to strengthen LSG revenues. It recommended adhoc annual grants to LSGs and focused on critical activities like maintenance of accounts, development of data base and audit. The Twelfth Finance Commission enlarged the grant to Rs. 25,000 crore but it tended to limit LSG fiscal needs to the traditional civic functions of water supply and sanitation.

Critique of the approach of the Finance Commissions

9.5 The Finance Commissions have tended to view decentralisation as a zero sum game as if the functions devolved on LSGs from the State Governments result in a simple displacement of pre-existing functionaries and funds and do not involve additional expenditure needs. This has not been borne out by experience. The Finance Commissions have not recognised the role of LSGs in the developmental sphere particularly in bringing about economic development and social justice; they have more or less confined themselves to the traditional view of LSGs as civic bodies whereas the Constitution envisages their transformation into "institutions of self-government" performing predominantly developmental functions. They have not attempted to identify the additional staffing requirements of LSGs even after the transfer of functionaries by the State Government. Since LSGs are fledgling institutions their capacity needs to be specially strengthened in the formative stages. They have not succeeded in identifying what constitutes good decentralisation and what the features of effective LSGs are. This is evident in the formulae developed by the Finance Commissions for distribution of grants. They have ignored the potential for incentivising States to decentralise in the larger interests of good governance and efficient application of resources; simultaneously they have failed to reward good performers which would have motivated others to move faster.

9.6 Thus, the Thirteenth Finance Commission has the rare opportunity to break new ground by giving a push for decentralisation of the right kind to achieve the ultimate objective of value for money in public expenditures, particularly those intended for the common man.

Kerala's Decentralisation initiatives

9.7 Kerala followed a rare, unorthodox, big bang approach to decentralisation – devolving a large basket of functional responsibilities along with staff and more than matching funds, all in a short space of time. This resulted in a series of reversals like giving responsibilities and then building capacity, giving power and then setting up proper systems for its exercise and giving funds and then putting in place procedures for their use and accounting. Kerala is the acknowledged fore-runner in the implementation of the constitutional mandate for strengthening LSGs and its decentralisation approach and methodology have been rated as the best in the country. In fact, it is a national model with tremendous scope for replicability. The arduous and risky path-breaking exercise of the State can be utilised by others for effortlessly going ahead with their decentralisation plans. A separate

document on Kerala's decentralisation is submitted to the Commission. However, its salient features are enumerated below : -

(i) Transfer of a wide range of functions to its Local Self Governments – these include: -

Primary and Secondary Health, Pre-primary, Primary and Secondary Education, Basic Technical Education, Nutrition Security, Social Security other than Welfare funds, Poverty Reduction, Women and Child Development (about 90 percent), Connectivity other than major district roads and highways, Water Supply (about 50 percent), Agriculture Development (about 75 percent), Social Justice (about 2/3^{rds}). Thus there is sharp mapping of functions and responsibilities among different tiers of LSGs and a rational division of labour between the State and LSGs. In this scheme of things, human development, poverty reduction, local economic development and provision of minimum needs including housing, sanitation, power, water and connectivity are now predominantly a Local Self Government responsibility.

(ii) Devolution of funds matching expenditure responsibilities, in a largely untied manner facilitating considerable local autonomy in prioritisation and allocation of resources – the State gives about a quarter of its State plan in this fashion.

(iii) Transferring staff to LSGs to discharge the transferred functions in a dual control system – even while the State Government is the staff-creating and cadre-controlling authority, LSGs have full freedom in assigning work, supervising its execution, reviewing performance and even imposing minor punishments, if required.

(iv) Setting up of independent umpiring institutions like Ombudsman and Appellate Tribunal to bring about accountability even while reducing executive control over Local Self Government functioning.

(v) Enhancing financial and social accountability through due process in budgeting, transparency in decision making, particularly selection of beneficiaries and expenditures and mandatory reporting of performance to constituents.

(vi) Participatory planning to ensure incorporation of people's priorities.

(vii) Institutionalised space for formal people's participation in governance – in priority setting, in implementation and in monitoring.

9.8 From the point of view of the Finance Commission, the following features of fiscal decentralisation of Kerala should be interesting.

(i) The Local Self Governments of Kerala, namely, the Village Panchayats, Municipalities and Corporations have very strong own tax domain consisting of property tax, profession tax, entertainment tax and advertisement tax. A service tax is in the offing. The Village Panchayats of Kerala mobilise the highest own revenue in the country – more than Rs. 100 per capita.

(ii) Kerala transfers funds to LSGs in three streams – Development Fund, Maintenance Fund and General Purpose Fund (Table 9.1).

Table 9.1 Devolution to LSGs (Rs. crore)

Year	Development Expenditure	Maintenance Expenditure	General Purpose	Total
2003-04	1284		*415	1699
2004-05	991	174	192	1357
2005-06	1008	307	250	1565
2006-07	1400	350	300	2050
2007-08	1540	385	330	2255
2008-09 (BE)	1671	398	363	2432

* Includes maintenance expenditure also.

(iii) It has to be specially mentioned that the funds transferred in the three streams are totally investible and are practically untied and these constitute the highest level of fiscal transfers to LSGs in the country, in relation to State Budgets. Further, unlike other States, salaries and pensions of transferred staff like teachers, doctors, engineers etc., are paid directly by Government and do not constitute a charge on the transferred resources.

(iv) Every single rupee is transferred in a non-discretionary manner through a formula which has considerable weightage for backwardness, ensuring fairness and equitability.

(v) There is absolute transparency in the transfer as LSG-wise allocations are indicated in a separate budget document of the State Government and presented to the Legislature.

(vi) There is total predictability of future resource flows as the Third State Finance Commission had recommended an automatic 10 percent annual increase in each of the three streams and this has been accepted and put into practice by Government.

(vii) The level of assuredness of funds is also very high as once budgeted they are non-divertible.

(viii) The smoothness of fund flow is also a special feature. Development Fund is transferred in 10 monthly instalments, Maintenance Fund in 10 monthly instalments and General Purpose Fund in 12 instalments automatically at the beginning of every month.

(ix) The General Purpose Fund is non – lapsable; Development and Maintenance Funds can be carried forward to the extent of 20 percent every year.

(x) A highly participatory budgeting process is in vogue.

Costs of Decentralisation

9.9 The experience of Kerala shows that decentralisation involves additional costs by way of the following:

(i) The service areas of institutions like primary health centres, veterinary hospitals, and krishi bhavans are coterminous with village Panchayats. This calls for provision of minimum level in terms of infrastructure, personnel and services leading to a need for gap filling and standardisation which is quite costly.

(ii) The high degree of public participation has had a two-fold effect – increase in awareness leading to increased access of public services and other entitlements and a greater outreach bringing out the hitherto marginalised and excluded groups who need to be provided with services and whose basic entitlements have to be met.

(iii) The participatory systems increase public demand for proper upkeep of infrastructure and public utilities which calls for regular maintenance.

(iv) LSGs have been spending more on creation of capital assets thereby leading to a higher requirement of funds for periodic maintenance.

(v) Though Government took a firm policy decision that decentralisation should not lead to net addition of staff as the principle of "work and worker going together" was adopted and put into practice through placement of staff performing the transferred functions and redeployment of surplus staff from certain non- transferred departments. After a decade certain serious deficiencies have been noted – in accounting staff, in audit staff both internal and external and in engineering staff. With computerisation, the need for an IT professional has arisen in all LSGs.

(vi) With the onset of new generation communicable diseases like Chickungunya and Dengue, waste management has assumed special importance in rural and urban areas requiring substantially increased effort on the part of LSGs, resulting in need for more resources in performing this traditional civic function.

(vii) LSGs meet the cost of public water supply standposts and street lights. With reforms in electricity and water utilities, market rates tend to be charged pushing up costs to LSGs.

(viii) In the Local Self Government system with five year rotations in reserved seats of women, Scheduled Castes and Scheduled Tribes there is a high turnover rate touching 85 to 95 percent every five years. This coupled with the fact that decentralisation has enhanced the responsibility of cutting edge staff, who combine in them the function of a Secretary as well as Head of Department of a Local Self Government, has generated a need for intensive capacity building.

(ix) Kerala has now reached the institutionalisation stage in decentralisation, where proper systems and procedures like office management system, procurement system, public work execution system, financial, accounting and audit management systems, personnel management system, data base management system, and the like have to be put in place. Decentralisation offers a rare chance for basic administrative and governance reform. This implies that the existing systems need to be fundamentally altered and modernised before adoption in the Local Self Government system. This is a resource-intensive expert task.

9.10 These points prove beyond doubt that the basic assumption of the earlier Finance Commissions that decentralisation does not generate additional costs is not validated by experience. Decentralisation is not a zero sum game; on the other hand, it introduces a kind of zoom effect resulting in clear understanding of local requirements and sharper articulation of priorities by the people calling for proper and better response from Local Self Governments for which they need to be supported. The Thirteenth Finance commission may therefore recognise this basic fact.

Suggested Approach

9.11 Articles 243 I and 243 Y provide for constituting State Finance Commission to determine the distribution of the net proceeds of the State's taxes, duties etc. between the State and the LSGs and the allocation of such proceeds among the LSGs at all levels. Article 280 (3) (bb) & (c) of the Constitution provides that it shall be the duty of the Central Finance Commission to recommend measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities on the basis of the recommendations made by the Finance Commission of the State. If decentralisation was to be a matter between States and Local Self Governments only,

such an amendment to the Constitution would not have been necessary. Therefore, it is evident that a portion of the resources to be devolved to the LSGs has to necessarily come from Centre through the transfers recommended by the Finance Commission. In this context, the Twelfth Finance Commission had earmarked Rs.25,000 crore for augmenting the consolidated fund of States for strengthening the resources of LSGs. Currently, the total expenditure of LSGs of all States comes to only 1.5 per cent of the GDP. In case the new pattern of fund transfer suggested in chapter 7 is not acceptable, the State is of the view that this has to be raised to 5 percent and half of the additional funds should be devolved to States for LSGs under Article 275.

9.12 Kerala has done commendable work in the area of decentralisation. The spirit behind the 73rd and 74th amendments to the Constitution has been fully imbibed and functions, functionaries and funds have been devolved to the Local Self Governments as per the provisions of the Constitution. In the matter of financially empowering LSGs, Kerala Government has followed a system fully consistent with the Constitutional provisions. State Finance Commissions were constituted in time and release of funds to LSGs was made on the basis of their recommendations. The Third State Finance Commission prepared its report broadly based on the pattern indicated in paragraphs 8.30, 8.31 and 8.32 of the Twelfth (Central) Finance Commission Report. It assessed the financial position of each of the 1215 LSGs in the State on the lines indicated in the Twelfth Finance Commission Report. On that basis it prepared financial profiles for each LSG, showing pre and post devolution (of share of State taxes to LSGs) position of each. The assessment in respect of one Panchayat is given in Table 9.2 as an example. This assessment indicated the forecast of

Table 9.2 Financial Profile of Local Self Government

Thrikkakkara Grama Panchayat (Rs. In Thousands)

Sl. No.	Item	2006-07	2007-08	2008-09	2009-10	2010-11	2006-11
1	Property Tax / Building Tax	8283	9005	9800	10674	11636	49398
2	Profession Tax	6522	7172	7887	8684	9539	39796
3	Entertainment Tax	82	86	91	95	100	454
4	Other Own Taxes	23	26	28	31	34	143
5	Total Tax Revenue	14911	16290	17806	19474	21309	89791
6	Non Tax Revenue	1483	1631	1794	1973	2171	9052
7	Total Own Revenues	16394	17921	19600	21448	23480	98842

8	Management & Collection Expre.	2825	3108	3419	3760	4136	17248
9	Civic Services Expenditure	12076	13284	14613	16074	17681	73728
10	Other Expenditure	0	0	0	0	0	0
11	Repayment of Debt	1205	1326	1459	1604	1765	7359
12	Total Expenditure	16107	17718	19490	21439	23582	98336
13	Deficit / Surplus	286	203	111	9	-103	506
14	Third SFC Funds (Excluding Maintenance Funds)	18579	20437	22480	24728	27201	113425
15	Net Position	18865	20640	22591	24738	27099	113932
16	ARM	1232	1355	1491	1640	1804	7521
17	Funds Available for Developing and Expanding Services and Institutions	20097	21995	24082	26337	28902	121453

Source: Third State Finance Commission (Kerala) Report - Appendix II

LSGs' own revenue, their expenditure on civic functions, the impact of share of State taxes (as recommended by the State Finance Commission) and reasonable yield from additional resource mobilisation as well as prudent level of borrowing. Following this pattern the Third State Finance Commission arrived at an assessment of funds available with each LSG, after meeting their requirements on discharging civic functions, for utilising in developing and expanding the institutions and services transferred to them by the State Government. That, according to the Third State Finance Commission, would be the amounts each LSG should generate (including tax share received from State Government) for development, consistent with the State Government's policy perception that LSGs are not merely agencies to take care of civic services but are also agents of economic development at the grassroots level. However, the State Finance Commission had to limit devolution of tax share to what the State Government could afford.

9.13 The declared policy of the State Government since 1995 has been to transfer at least 35 percent of the State Plan outlay (including State Sponsored Schemes or 1/3rd of State plan outlay excluding such schemes) each year to LSGs as reported in the State Finance Commission Reports. The Third State Finance Commission recommended transfer of about 25 percent of the total State tax revenue of the year 2003-04 to LSGs during 2006-07. For the subsequent four years amounts derived by applying the annual growth of 10 percent were recommended. But this is not enough to meet the development expenditure of LSGs. Recognising this fact and the policy goal of the State Government it further recommended that over and above the statutory transfer of funds to Local Self Governments stipulated by it, the State might provide additional funds for developmental activities subject to

availability (chapter 12 of its Report). The total amount required by LSGs for the five year period 2006-11 worked out by the Third State Finance Commission is Rs.10,772 crore (Table 9.3). The aggregate amount in 2008-09 has been worked out to

Table 9.3 Fund availability with LSGs (Rs. crore)

	2006-07	2007-08	2008-09	2009-10	2010-11	2006-11
Total amount available with LSGs for development expenditure, including share of taxes	1773	1945	2136	2345	2574	10772

Rs. 2136 crore. If 35 percent of the State Plan of 2008-09 (plan size being Rs.7700 crore) is to devolve to LSGs for development expenditure, the additional amount required will be Rs 2695 crore thus leaving a gap of Rs. 559 crore in one year. On projecting a nominal 10 percent annual growth beyond 2010-11 up to the Thirteenth Finance Commission award period, this will add up to Rs 4129 crore. Considering the extent of funds already being given to the LSGs and the availability of resources, the State is certainly not in a position to provide such additional funds. Paragraph 8.30 of the Twelfth Finance Commission Report concludes that such gaps that remain after the above exercise would then constitute the basis for the measures to be recommended by the Central Finance Commission.

9.14 However, we do recognise that the Commission may not be able to give special grant under Article 275 on the basis mentioned above as many of the States have not followed the Constitutional amendments and put in place the credible mechanism of State Finance Commission. In such a situation, the State urges the Thirteenth Finance Commission to augment the consolidated fund of the State for strengthening the resources of the LSGs through grants under Article 275 by using the following formula:

Criteria	Weight (percentage)
Population (1971 census)	60
Geographical area (adjusted)	5
Income distance (scaled to 1971 population)	10
Index of decentralisation	25

The parameters of index of decentralisation should be (i) percentage of untied investible funds devolved to LSGs as percentage of State Budget and (ii) percentage of own revenue of LSGs as percentage of State's Own Revenue.

9.15 In addition, apart from the above grant that the State would be eligible for augmenting the resources of the local bodies, we are of the view that Kerala needs to be suitably rewarded for its trend setting role it has played in developing and strengthening its Local Self Governments at great cost and effort. This has a two-fold justification – the processes, procedures and systems developed by Kerala can be adopted at no cost by other States and such a reward could motivate them to perform well in this regard. Moreover, Local Self Governments in Kerala have reached a stage of development where they now need funds to ensure capacity building, one time maintenance and rehabilitation expenditure for transfer of single Panchayat water supply schemes from Kerala Water Authority to Village Panchayats, solid waste management and introduction of electronic voting machines to further strengthen the grass roots democracy and enhancement of social security through a partnership of Local Self Governments and Community Based Organizations of poor women under Kudumbashree following the 'Asraya' model which has won the Prime Minister's Award as a best practice in good governance. Hence the State would urge the Commission to provide additional special grants under Article 275 in all these areas for which detailed proposals are submitted to the Commission separately.

Chapter 10

DISASTER MANAGEMENT

10.1 Natural disasters are events of nature which cause sudden disruptions to the normal life of a society. They also invariably cause damage to property and life to such an extent that normal social and economic mechanisms that are locally available to the society become inadequate to restore normalcy. The State of Kerala is vulnerable to a number of natural calamites such as coastal erosion, floods, cloudbursts, droughts, lightning, landslides etc. with locational and geographical features contributing to them. Almost all the districts in the State are multi-hazard prone. Most of the 560 km coastline of Kerala is frequently subjected to coastal erosion of varying degrees.

10.2 Disaster management occupies an important place in the State's policy framework as it is the poor and the under-privileged who are often worst affected on account of calamities/disasters. A paradigm shift in the approach to disaster management from response to preparedness is necessary because investments in mitigation are much more cost effective than expenditure on relief and rehabilitation. Disaster Management is to be considered a multi-disciplinary function and integrated into all sectors of development.

10.3 As per sub-section (1) of section 48 of the Disaster Management Act 2005, the State Government is required to establish the Disaster Response Fund and the Disaster Mitigation Fund at the State Level and Districts Level. After establishing these funds, the State Disaster Management Authority and the District Authority will have to avail of sufficient funds for managing the various disasters.

10.4 At present, the State Government has the Calamity Relief Fund (CRF) for the natural calamity relief activities in the State. It consists of 75 percent Central share and 25 percent State share. Experience has shown that the funds available for calamity relief operations have been insufficient given the occurrence and magnitude of the natural calamities in Kerala. The CRF earmarked for the period 2005 - 2010 to Kerala is of the order of Rs.472.42 crore out of which the Central contribution is Rs.354.32 crore. For a State like Kerala which faces multiple calamities almost every year, the corpus of the Fund is very meagre.

10.5 The Calamity Relief Fund now available with the State is so inadequate that there is no money left for constituting the Response and Mitigation Funds at the State Level and District Level. Hence the funds available for relief activities should be enhanced considering the natural calamities frequently occurring in Kerala and the need for special attention to preventive and mitigating measures.

10.6 In this backdrop, the State will urge the Commission to enhance the corpus of the CRF to 10 percent of the amount of the annual State Plan size of the concerned State and also increase the contribution of the Centre to the Fund to 90 percent. In the case of severe calamities, advance drawal up to 100 percent of next year's provision may be allowed. The unspent balance of CRF at the end of the five year plan period may be allowed to be used as a resource for the next plan. In view of the regional disparities in terms of costs on account of labour, materials, terrain etc., States may be permitted to fix their own norms for utilisation of the CRF. For instance, unit cost to determine the quantum of loss, provision of debt relief to people affected by natural calamities in certain situations etc. may be allowed from the CRF. Additional grants may also be provided to set up the Response Fund and the Mitigation Fund at State and District levels.

10.7 Sea erosion is one of the recurring natural hazards affecting the coastline in the State. Generally, it occurs as part of erosion - accretion cycle. It is feared that with the predicted rise in sea level, as a result of the green house effect, the rate of beach erosion and loss of coastal properties are going to increase. Kerala has 560 Km long coastline; more than half of the area of the State is only 4 meters above sea-level and encroachment by the sea severely affects the economy of the State. Kerala has 44 rivers crisscrossing the State and most of them flow into the sea. The State has the second largest density of population after West Bengal. A substantial part of population not only lives close to the coastline but also lives off it and they belong to the vulnerable sections of the society. With high density of population and major establishments along the sea coasts, large investments have to be made to erect shore protection structures and take up other mitigating measures.

10.8 Similarly, lightning strikes also cause heavy loss of lives in the State. Looking at the Statistics, Kerala has high lightning incidence compared to nearby regions. On an average, 188 such incidents occur every year in which 71 people die and 112 people are injured. The statistics was obtained as a result of an investigation conducted by the Centre for Earth Science Studies, Thiruvananthapuram.

Knowing that lightning cannot be prevented, the obvious choice for reducing personal injury is to find ways to avoid it or take protective measures. It is clear that the people in the State bounded by the Western Ghats have a problem different from elsewhere in regard to lightning and so we have to take special efforts to combat this hazard.

10.9 Non-inclusion of sea erosion and lightning as natural calamities entails on the State a huge expenditure to rehabilitate the victims and provide them with food and clothing. In the last 20 years, 4000 deaths have occurred in the State due to lightning and sea-erosion, for which no financial assistance under Calamity Relief Fund could be given or used. The State has recently witnessed a new phenomenon of heavy unseasonal rains causing massive water logging and extensive damage to crops. Therefore, the State earnestly urges the Commission to recommend including sea erosion, lightning and waterlogging among natural calamities.

10.10 The National Calamity Contingency Fund (NCCF) was set up with an initial corpus of Rs 500 crore on the recommendation of the Eleventh Finance Commission. In view of the magnitude of the severe calamities faced by various States, often at the same time, the corpus has proved to be inadequate. Hence, there is a need to enhance the corpus. An annual rate of inflation of 8 percent may be added for each year since the constitution of the Fund to peg the corpus at Rs.1000 crore during the award period of the Thirteenth Finance Commission. The Commission may also recommend suitable measures to avoid delay and discretion in providing assistance by Centre from the NCCF to the needy States.

Chapter 11

SUMMARY OF MAIN SUGGESTIONS

11.1 The Thirteenth Finance Commission has the unique opportunity to initiate a much needed course correction reversing a trend that has been eroding the very concept of fiscal federalism (vide Paras 1.6 & 1.7).

11.2 The steady decline of fiscal federalism over half a century as briefly narrated in chapter 2 should be reversed. It is also necessary to correct the impression that State Governments are inherently incapable of managing their finances (vide Para 2.14). With these two objectives, a course correction has to be attempted on the following lines:

? Primacy of Finance Commission in steering Centre-State financial relations should be reaffirmed. ? As Finance Commission transfer is the manifestation of a Constitutional right of States to get a share of Central revenues, it should not be loaded heavily with conditions to be administered by Central Ministries.

? Primacy of the State Plan (and Gadgil formula assistance) should be reasserted as the vehicle for developmental efforts. All priority areas and problems special to each State should largely be tackled in the State Plan.

? Central plan should not intrude into areas coming within the duties and responsibilities of States under the Constitution. Developmental schemes in such areas should be mostly left to be tackled by State Plans.

? To achieve this, the size of State Plans would have to be increased and more Central revenue should be given as Gadgil formula grants (Central assistance should have no Central loan component – except back to back external aid).

? Revenue transfers and distribution among States should not cause heartburn either to weak or to other States. The range of deviation from average per capita transfer, particularly share of Central taxes, should be rationalised.

11.3 States' share of Central taxes should be increased from 30.5 to 50 percent of the divisible pool. If this cannot be done in one year's time it may be spread over five years from 2010-11. The Commission may also indicate a cap of 65 percent of the divisible pool of each year, for the total transfer of (non-loan) resources from Centre to States, as indicated in Table 7.3.

11.4 New pattern suggested in chapter 7 for realignment of the different components of transfer of resources from Centre to States may be recommended for implementation.

11.5 Fix a minimum limit for block grants distributed solely as per Gadgil formula. This should be distributed among all the twenty eight States on the basis of the various criteria and weights under the revised Gadgil formula.

11.6 In deciding horizontal devolution, population factor should have the highest weight for reasons indicated in Paras 5.7 to 5.10.

11.7 When income distance is taken as a factor it should definitely be scaled to population and that too 1971 population (vide Para 5.11).

11.8 The share of Central taxes may be distributed among States based on the following criteria and weights: Population - 70 %, Income distance - 10 %, Area (adjusted) - 5 %, Tax effort -10 % and Fiscal performance - 5 %.

11.9 The per capita (1971 population) share of taxes of the State with the highest per capita share should not be more than 150 percent of the per capita share of the State, which gets the lowest per capita share (vide Para 5.18).

11.10 In any direct or indirect application of population factor, population based on 1971 census should be taken as this has the sanction of Parliament as part of the population control policy (vide Para 5.19).

11.11 Every year Finance Ministry should prepare a detailed statement of the amount given to each State under each of the categories and present it in the National Development Council and in the Parliament.

11.12 It is also necessary to give an annexure showing how each State's share in Central taxes has been worked out. This is absolutely essential in the interest of transparency in deciding such an issue of great national importance.

11.13 The Commission may also review the calculation for arriving at the divisible pool from the gross tax revenue in the Central Budget so that States do not lose revenue on account of any flaw in the method of arriving at the amount.

11.14 The approach to grants-in-aid under Article 275 should be (i) to fill the gap in availability of revenue account resource on the non-plan side (ii) to fill gap, if any, in the revenue account on the plan side at the existing level. (iii) after such gap filling, States with either no per capita surplus or

only meagre surpluses may be given additional grants under Article 275, on the basis of norms, to augment their revenue account in order to ensure that adequate surplus is available for capital investment as required in Para 6(iv) of the ToR.

11.15 Additional grants for State specific needs arising out of special problems may be granted under article 275 as proposed in chapter 6.

11.16 States' share of Open Market Borrowings should be fixed at 33.33 percent in 2010-11 which may be steadily increased to 50 percent by 2014-15. The grant portion of Normal Central Assistance may be enhanced from 30 percent to 50 percent (vide Para 8.10). All past Central loans and interest thereon should be waived. In the case of NSSF, rates of interest on the loans including the past loans may be aligned with the rates of interest being given to the investors after adjusting for cost of collection.

11.17 Local Self Government expenditure has to be raised from 1.5 to 5 percent of GDP and half of the additional funds should be devolved to States for LSGs under Article 275 as proposed in Para 9.11. Inter-se allocation to States for strengthening LSGs may be determined using the following formula: Population (1971 census) – 60 %, Geographical area (adjusted) – 5 %, Income distance (scaled to 1971 population) – 10 % and Index of decentralisation – 25 % (vide Para 9.14). Additional special problem grant under Article 275 also sought for capacity building etc. for LSGs in the State (vide Para 9.15).

11.18 Enhance the corpus of the CRF to 10 percent of the amount of the annual State Plan size of the concerned State and also increase the contribution of the Centre to the Fund to 90 percent. In the case of severe calamities, advance drawal up to 100 percent of next year's provision may be allowed. States may be permitted to fix their own norms for utilisation of the CRF. Additional grants may also be provided to set up the Response Fund and the Mitigation Fund at State and District levels. Include sea erosion, lightning and water logging among natural calamities. Corpus of the NCCF may be raised from Rs. 500 crore to Rs. 1000 crore.