GOVERNMENT OF KERALA

MEDIUM TERM FISCAL POLICY & STRATEGY

STATEMENT

WITH

MEDIUM TERM FISCAL PLAN

FOR KERALA

2008-09 To 2010-11

FINANCE DEPARTMENT

2008

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STATEMENT OF COMPLIANCE

- *This 2008-09 Medium Term Fiscal Policy and Strategy Statement is placed before the Legislature in compliance with section 3 of the Kerala Fiscal Responsibility Act, 2003.*

- *Section 3 of the Act requires the Medium Term Fiscal Policy Statement to include the following elements all of which have been incorporated in the document:*

  1. *Three year rolling targets for fiscal indicators with specification of underlying assumptions.*
  2. *An assessment of sustainability relating to the revenue deficit and the use of capital receipts for generating productive assets.*
  3. *The medium term fiscal objectives of the Government.*
  4. *An evaluation of the performance against targets for 2007-08 and 2008-09.*
  5. *A statement of recent economic trends and prospects for growth and development.*
  6. *Policies of Government for the ensuring financial year relating to taxation, expenditure, borrowings and other liabilities, etc.*
  7. *The strategic priorities and key policies of the Government.*

FOREWORD

I present the Medium Term Fiscal Policy and Strategy Statement for Kerala for 2008-09. This is in pursuance of the statutory requirements for such a statement as per the Kerala Fiscal Responsibility Act and the rules there under.

Last year, I had expressed the view that the State is poised for fiscal consolidation in the coming years. I am glad to state that the 2007-08 Revised Estimates indeed bear out this expectation. I am further glad to report that the 2008-09 Budget Estimates also point towards further consolidation. If past experience is any guide, the final figures of fiscal indicators for 2007-08 and 2008-09 should both show improvement over the projections now made.

The projections for 2009-10 and 2010-11 show excellent consolidation, with the Revenue Deficit disappearing altogether by end of 2010-11. Even the Government of India has announced the delay of 1 year for achieving the Centre's Revenue Deficit targets i.e. end 2010 instead of end 2009, as stipulated in the Central FRBM Act. Kerala will follow its own path to fiscal consolidation and reach the goal by end 2010-11. This is considered commendable for a State, which, just a few years ago was struggling to find its feet and keep the treasury open. The fiscal space so created in the coming years will be most fruitfully used to increase capital outlay, which in turn is expected to spur the economy to further growth in future.

I seek the full cooperation of all stakeholders in attaining the objectives of fiscal correction and robust economic growth.

6th March, 2008

Dr.T.M.Thomas Isaac,
Finance Minister

Medium Term Fiscal Policy and Strategy Statement with Medium Term Fiscal Plan for Kerala

1. Overview

1.1. Last fiscal year has seen significant fiscal consolidation at Central as well as State level. High growth and buoyant revenues have contributed to the significant reduction in combined Fiscal Deficit of Centre and State in 2006-07. The RBI study on State Finances of 2007-08 shows that all-State Fiscal Deficit will decline to below 3 percent of GDP. Though fiscal consolidation seems to have been achieved at all-State level, questions have been raised regarding the quality of fiscal adjustment. In Kerala, we are on a path of fiscal consolidation. We have also been able to bring in greater transparency in fiscal management by adopting pro-poor fiscal policy, without resorting to fiscal squeeze. Kerala has been able to consolidate its finances, through better own revenue mobilization and improved fiscal management in a transparent and efficient manner.

1.2. The Revenue Deficit of Kerala, which was as high as 3.43 percent of GSDP in 2004-05 declined to 1.99 percent of GSDP in 2006-2007, i.e. a reduction of 1.44 percentage points in two years. The Fiscal Deficit has also declined from 4.16 to 2.88 percent of GSDP during the same period. Although the State's fiscal imbalance profile seems to tilt towards greater imbalance in 2007-08, it is due to the full implementation of the Pay Commission award, clearing up of arrears and significant increase in development spending. This imbalance has happened despite a very high growth of own tax revenues. On an average, own tax revenues have grown at the rate of 20 percent in the last two years. With this buoyant revenue growth, due to the pro-active steps taken by the Government of Kerala, we shall be able to improve the fiscal position of the State significantly in the near future. As per Budget estimate, the revenue deficit of 2008-09 will be maintained at 2006-07 level of 2 percent of GSDP and the fiscal deficit is expected to be 3.4 percent of GSDP. Our medium term fiscal plan is set to achieve a target of elimination of revenue deficit and keeping the fiscal deficit at below 3 percent of GSDP by the end of 2010-11.

2. State Macro Economic Scenario in the context of National Economy

2.1. Though there has been a downward adjustment in the national GDP growth rate in 2007-08 at 8.7 percent, the Kerala economy has shown a buoyant growth rate last year. If we compare the Kerala GSDP growth rate with the National GDP, it is evident that the Kerala economy is fast catching up. In real terms, the GSDP of Kerala has grown at the rate of 6.77 percent during the fist half of the decade of 2000, while the national economy has grown at the rate of 6.9 percent. Kerala's GSDP growth in real terms increased further during the last two years. Sustained high growth in Kerala has contributed to the increase in real per capita income of the State. The State's economy is projected to grow at the rate of 11.9 percent in nominal terms during 2007-08, i.e. a real growth of more than 8 percent. In other words, it is now certain that the average annual growth rate of the State's economy will be more than 8 per cent during the 10^{th} plan period.

2.2. Apart from the macro economic performance, when we discuss the medium term fiscal strategy for Kerala, it needs to be emphasized that Kerala's achievements in social sector and human development, though well known, could only be sustained due to the pro-social sector fiscal policy stance taken and continued by the present Government, despite pressure of conditionality for fiscal reforms imposed by the Central Government and uniform deficit targets set by the Twelfth Finance Commission. We want increased spending on developmental sectors so that we are able to sustain our social sector achievements and enhance it further for higher growth and development.

2.3. Another important issue that comes up in the context of MTFP is the issue of resources for infrastructure. Infrastructure bottlenecks can be a severe impediment to growth. The current Government is aware of this and has increased capital expenditure. The capital expenditure, which was 0.64 per cent of State GSDP in 2004-05 increased to 0.68 per cent of GSDP in 2006-07 and as per the RE 2007-08, it is expected to be 1 per cent of GSDP. As mentioned earlier, increase in developmental spending is also one of the reasons for the increase in fiscal deficit as per the RE 2007-08. The 2008-09 BE also shows the capital expenditure at around 1 per cent of GSDP. If we have to meet our infrastructure needs, we need more capital spending in the next two years and the MTFP proposed here does make provision for higher capital spending without violating the fiscal deficit target of 3 per cent of GSDP.

3. <u>State Finances: Assessment of Sustainability, Strategic Priorities, Key Policies and Medium Term Fiscal Objectives</u>

3.1. To put issues in perspective, it is important to understand how this consolidation is achieved in Kerala in the last three years and how we are going to achieve further fiscal consolidation in the next two years. As can we see from the Table 1, between 2004-05 and 2008-09 BE, the own tax revenue buoyancy has been phenomenal. The own tax effort has increased from 8.4 to 9.6 per cent of GSDP during this period. During this period, the State also has benefited from higher Central transfers, mainly due to tax devolution due to higher growth of Central revenues. This is a general phenomenon and it is not peculiar to Kerala. However, revenue expenditure also has gone up, primarily due to the salary revision and increase in pension. However, the BE 2008-09 envisages stabilization of these committed expenditure as a per cent of GSDP. It is also to be noted that despite the increase in committed expenditures like salary and pension, the combined share of committed expenditures, viz, salary, interest and pension in total revenue expenditure remained more or less the same during this period at around 67 per cent. However, as a percentage of revenue receipts, combined share of salary, pension and interest payment has declined sharply from 86 per cent to 65 per cent during 2004-05 to 2008-09 BE. The other positive achievement is the step up in capital expenditure. The capital expenditure to GSDP ratio increased from 0.64 to 1 per cent during 2004-05 to 2008-09 BE. This has in turn contributed to the increase in fiscal and revenue deficit.

Table 1 : Overview of State Finances
(Percent to GSDP)

	2004-05	2005-06	2006-07	BE 2007-08	RE 2007-08	BE 2008-09
Revenues	**12.6**	**12.9**	**13.7**	**13.9**	**14.5**	**15.1**
Own Tax	8.4	8.2	9.0	8.9	9.4	9.6
Own non-Tax	0.8	0.8	0.7	0.7	0.7	0.8
Central Taxes	3.5	3.8	4.0	4.2	4.3	4.8
Revenue Expenditure	**16.0**	**15.5**	**15.7**	**17.3**	**17.6**	**17.1**
Salary	5.0	4.7	4.9	5.8	5.6	5.6
Interest	3.4	3.2	3.2	3.1	3.2	3.1
Pension	2.4	2.4	2.5	3.0	3.1	2.8
Capital Expenditure	0.64	0.69	0.68	0.86	1.01	0.95
Revenue Deficit	-3.43	-2.63	-1.99	-3.41	-3.13	-2.04
Fiscal deficit	-4.16	-3.51	-2.88	-4.82	-4.65	-3.41
Primary Revenue Deficit (-)*	-0.05	0.56	1.17	-0.31	0.08	1.08
Primary Fiscal Deficit (-)*	-0.78	-0.32	0.28	-1.72	-1.44	-0.29
Outstanding Debt	39.1	38.6	37.6	37.1	37.8	37.6

* : Negative (-) means "Deficit" and positive means "surplus"

4. **Debt Liabilities**

4.1. The debt to GSDP ratio has been arrested at around 38 per cent from 2006-07 and we expect that it would be 37.6 per cent of GSDP in 2008-09 BE. This will come down to 35.4 by 2010-11. The debt to revenue ratio also has fallen consistently over the last three years and is expected to be 215 per cent in 2008-09 and will drop to 209 per cent by 2010-11. The rate of growth of State debt has also slowed down.

4.2. The issue of sustainability of State debt was examined at length in the MTFPSS 2006-07. The position has improved significantly since. The debt revenue ratio has come down much below 300 per cent, the threshold at which Government of India classifies a State as debt stressed. Although, interest payment to revenue receipts ratio is still above 20 per cent, it has nevertheless declined steeply and that trend is expected to continue in 2008-09 (20.7%). The difference between the nominal GSDP growth rate and the interest rate paid on debt, which is an indication of debt sustainability, has widened further because of higher growth rate and lowering of the average cost of debt.

4.3. The debt profile of the State has changed dramatically over the last decade, with the share of Central debt coming down and that of market borrowings, especially small savings (NSSF), rising sharply. NSSF flows have shown sharp downward trend in recent years on account of withdrawal of institutional investors, changes in tax laws, and more recently the rise in market rates of interest. The State will have to increasingly fall back on market borrowing to counter this trend.

4.4. The decline in the debt accretion is paralleled by the downward trend in off balance sheet contingent liabilities in the form of Government guarantees. The total outstanding guarantees of both principal and interest, which stood at Rs.12316 crore as on 31.03.2005, declined to Rs.11935 crore as on 31.03.2006 and Rs.9405 crore as on 31.03.2007. It is expected to stabilize at Rs.9000 crore from now on. The statutory limit prescribed under the Act is Rs. 14000 crore.

5. Overall Assessment

5.1. In order to sustain the fiscal improvement that has been achieved, we need to continue various reforms and fiscal management measures introduced by the Government. Despite the reduction in the share of committed expenditure / liabilities in total Government expenditure, the fiscal space that is available is still limited. Apart from effective and credible expenditure rationalization and additional resource mobilization, revenue reforms including, inter alia, automation of the tax administration and greater devolution of service tax by the Centre are crucial for placing the State finances on a sustainable fiscal consolidation path.

6. Review of MTFP Targets and Policies for the Ensuing Year

6.1. As evident from the box below, the State has been able to consolidate its fiscal position and remained below the targets of both revenue and fiscal deficits set for the MTFP 2007-08. However, the primary deficit exceeded the target of MTFP of 2007-08. This is due to the increase in fiscal deficit due to the full implementation of Pay Commission's recommendation, clearing of arrears, increased developmental expenditure, etc.

Box 1: MTFP Targets and Actual Outcome

The fiscal targets for 2007-08 were as follows:

- ✓ A fiscal deficit equivalent to 4.8 per cent of GSDP
- ✓ A revenue deficit equivalent to 3.4 per cent of GSDP
- ✓ A primary revenue deficit equivalent to 0.3 per cent of GSDP

Actual outcome 2007-08 (RE)

- ✓ A fiscal deficit equivalent to 4.65 per cent of GSDP
- ✓ A revenue deficit equivalent to 3.1 per cent of GSDP
- ✓ A primary revenue surplus of 0.1 per cent of GSDP

7. Fiscal Policy Framework

7.1. The budget is presented against the backdrop of high growth rate but uncertain macro economic environment at national level, characterized by moderate inflation, lowering of growth momentum and rise in interest rate. The Eleventh Plan of the State Government which has been pegged at Rs.40422 crore at current prices, including an outlay of Rs.7605 crore in 2008-09, has attempted to provide necessary correctives. The State is also of the view that it continues to be penalized for the investment made by it in the past to attain best human development indicators in the country, because Central assistance is basically benchmarked to size and backwardness. This Government's fiscal policy framework can be summarized as follows:

i) While ensuring sustainable and accelerated growth, Government would need to take special measures to make growth broad based and equal.

ii) Take measures to overcome the agrarian crisis and problem of educated unemployment and eliminate poverty. Traditional industries and petty production would be supported and made viable.

iii) Lay greater emphasis on strengthening Kerala's remarkable achievement in human development that is threatened by the sharp drop in social sector expenditures. Restructuring of subsidies and expenditure priorities must be consistent with the objective of defending, widening and strengthening human development indicators.

iv) Emphasis on knowledge based industries, service based industries and skill based industries that are all areas of core competency of the State.

v) Continuing tax reforms to widen the tax base and increasing compliance.

vi) While fostering a robust investor friendly and growth oriented environment that would facilitate both private and public – private initiatives, the public sector will be made viable and strengthened.

vii) Integrated development of physical infrastructure in roads, airports, ports, power, water supply and urban infrastructure.

viii) Fiscal empowerment of LSGIs and administrative reforms to ensure greater accountability and transparency.

8. Deficit Targets for 2008-09 and Government Debt.

8.1. The deficit targets for 2008-09 are as follows:

- ✓ A fiscal deficit equivalent to 3.4 per cent of GSDP
- ✓ A revenue deficit equivalent to 2 per cent of GSDP
- ✓ A primary revenue surplus equivalent to 1 per cent of GSDP
- ✓ A primary fiscal deficit equivalent to 0.3 per cent of GSDP

8.2. As a result of these targets and taking into account the revised fiscal deficit of 2007-08, public debt is projected to increase from Rs.56056 crore as on 31-3-2008 to Rs.61975 crore on 31-3-2009. The debt sustainability ratios as on 31-3-2009 would change as follows, relative to 31-3-2007.

Table 2: Debt Sustainability Ratios

Parameter	2006-07	2007-08 RE	2008-09 BE
Debt/GSDP (%)	37.6	37.8	37.6
Debt/Revenue Receipts (%)	274.2	260.8	248.9
Interest /mid year Debt (%)	8.75	8.98	8.72
Interest / RR (Prudent level < 20)	23.0	22.1	20.7
Domar Gap: GSDP growth rate minus cost of borrowing.	2.80	2.88	2.41

9. Three – Year Rolling Targets and Underlying Assumptions

9.1. The three year rolling target are given in Table 3

Table 3: Three-Year Rolling Targets

	2004-05 Accounts	2005-06 Accounts	2006-07 Accounts	2007-08 RE	2008-09 BE	2009-10 Forward	2010-11 Estimates
GSDP Growth Rates (%)	11.50	11.16	11.55	11.86	11.12	12.12	11.89
RD/GSDP (%)	-3.43	-2.63	-1.99	-3.13	-2.04	-1.02	0.02
RD /Revenue Receipts (%)	-27.17	-20.46	-14.50	-21.60	-13.52	-6.45	0.11
FD /GSDP (%)	-4.16	-3.51	-2.88	-4.65	-3.41	-2.97	-2.77
FD /Revenue Receipts (%)	-32.97	-27.34	-21.01	-32.10	-22.60	-18.86	-16.85
Debt / GSDP (%)	39.12	38.60	37.57	37.75	37.56	36.47	35.37
Debt/RR (%)	310.2	300.3	274.2	260.8	248.9	231.6	214.8
Interest/ GSDP (%)	3.37	3.19	3.16	3.20	3.12	3.00	2.90
Interest /RR (%)	26.76	24.84	23.04	22.13	20.66	19.7	17.61
(Salary + Pension + Interest)/GSDP (%)	10.80	10.31	10.58	11.91	11.45	11.03	10.65
(Salary + Pension + Interest)/Revenues (%)	85.6	80.2	77.2	82.3	75.9	70.1	64.7
(Salary + Pension + Interest)/Rev Expnd (%)	67.3	66.6	67.4	67.7	66.9	65.8	64.8
Primary Deficit / Surplus (Rs. crore)	-55	670	1552	114	1777	3675	6038
Primary Fiscal Deficit (-) / Surplus (Rs. crore)	-838	-383	368	-2142	-482	61	256

9.2. Based on the past trend rates of growth of key variables on revenue and expenditure side, the fiscal imbalance profile has been estimated. The MTFP does not resort to fiscal squeeze but emphasis on higher revenue growth. We assume that past own revenue growth of last two years will continue for 2009-2010 and 2010-2011. In other words, own tax revenue is assumed to grow at the rate of 17 percent. Non tax revenue is also expected to grow at the same rate. We are also making additional effort to maintain higher non tax revenues to keep it constant in Real Terms. We also assume that Central transfers will continue to grow as it has grown in recent past, at 17 percent, which in our view is a reasonable assumption to make, unless there is a drastic change in the Central transfers arising out of the recommendations of the Thirteenth Finance Commission. That would only affect the last year of our projection, i.e, 2010-11. The interest payment is estimated based on the average cost of debt in the base year 2008-09. It will grow at around 8% only.

9.3. We assume that non-SPI expenditure will grow based on its past trend. It is important to note that between 2004-05 and 2008-09 BE, revenue expenditure excluding salary, pension and interest payment has grown at the rate of 15.25 per cent when the overall revenue expenditure has grown at the rate of 12.97 per cent. In other words, revenue expenditure growth in recent years is driven not by committed non-developmental expenditure but by developmental revenue expenditure.

9.4. In the MTFP framework, the capital expenditure is residually determined given the borrowing limit of 3 per cent. It is to be noted that, with 3 per cent fiscal deficit, the capital expenditure goes up from 0.95 per cent of GSDP in 2008-09 to 1.93 per cent of GSDP, which is more than 100 per cent growth of capital expenditure in the just two years. Thus, to conclude, the fiscal profile would achieve a target of elimination of revenue deficit by 2010-11 and would bring down the fiscal deficit to 3 percent with an increase in fiscal space for higher capital spending for higher growth and development. The details are in Annexure I.

Annexure I

KERALA-MEDIUM TERM FISCAL PLAN

					(in crore)		Forward estimates		
Sl No	Item	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	Growth
		Accounts	Accounts	Accounts	RE	BE			Rate
1	**Revenue Receipts**	**13501**	**15295**	**18187**	**21497**	**24896**	**29128**	**34080**	
I(a)	State own tax revenue	8964	9779	11942	13997	15781	18464	21603	17.0%
I(b)	Non Tax Revenue	819	937	938	1084	1254	1467	1717	17.0%
1(c)	Resources from centre	3718	4579	5307	6416	7861	9197	10761	17.0%
2	**Revenue Expenditure**	**17169**	**18424**	**20825**	**26141**	**28263**	**31008**	**34042**	
	Non-Interest Revenue Expenditure	*13556*	*14625*	*16635*	*21383*	*23119*	*25453*	*28042*	
2(a)	Interest	3613	3799	4190	4758	5144	5556	6000	8.0%
2(b)	Salaries	5346	5610	6560	8340	9187	9922	10716	8.0%
2(c)	Pensions	2601	2861	3295	4592	4569	4935	5329	8.0%
2(d)	*Non SPI Revenue Expenditure*	*5609*	*6154*	*6780*	*8451*	*9363*	*10596*	*11997*	
2(d) (I)	Subsidies (food, Housing, Transport and Industry)	138	150	267	206	171	197	226	15.0%
2(d) (ii)	Power subsidy	0	0	0	0	0	0	0	
2(d) (iii)	Maintenance & repair (Roads, Buldings & irrigation)								
2(d) (iv)	Maintenance & repair (Edn,Health,RD,WS, Agriculture & Forest)	318	401	369	521	526	605	696	15.0%
2(d) (v)	Devolution to LBs	1783	1565	1911	2275	2430	2673	2940	10.0%
2(d) (vi)	Administrative Expenditure	950	1023	1210	1602	1649	1847	2069	12.0%
2(d) (vii)	Other Revenue Expenditure	2420	3015	3022	3847	4587	5275	6066	15.0%
3	**Revenue Surplus/Deficit**	**-3668**	**-3129**	**-2638**	**-4644**	**-3367**	**-1880**	**38**	
4	Capital Expenditure	682	817	903	1499	1562	2499	3999	60.0%
5	Net Loan disbursements	-101	-236	-281	-757	-697	-1115	-1784	60.0%
6	**Fiscal Deficit**	**-4451**	**-4182**	**-3822**	**-6900**	**-5626**	**-5494**	**-5744**	
7	Primary Fiscal Deficit/Surplus	-838	-383	368	-2142	-482	61	256	
8	**End of the period Debt**	**41878**	**45929**	**49875**	**56056**	**61975**	**67469**	**73213**	
9	Debt Service	3613	3799	4190	4758	5144	5350	5525	
10	Salary+Pension+Interest	11559	12270	14045	17690	18900	20412	22045	
11	Explicit Power subsidy	0	0	0	0	0	0	0	
12	Consolidated Capital Expenditure	783	1053	1184	2256	2259	3614	5782	
13	Debt Stock	41878	45929	49875	56056	61975	67469	73213	
14	Government Guarantees	12316	11935	9405	9000	9000	9000	9000	
15	Interest/Revenue	26.8%	24.8%	23.0%	22.1%	20.7%	19.1%	17.6%	
16	Debt/Revenue	310.2%	300.3%	274.2%	260.8%	248.9%	231.6%	214.8%	
17	(Salary+Pen+Interest)/Revenue	85.6%	80.2%	77.2%	82.3%	75.9%	70.1%	64.7%	
18	(Salary+Pen+Interest)/GSDP	10.8%	10.3%	10.6%	11.9%	11.5%	11.0%	10.6%	
19	(Salary+Pen)/GSDP	7.4%	7.1%	7.4%	8.7%	8.3%	8.0%	7.8%	
20	Rev Deficit/Rev Receipt	-27.2%	-20.5%	-14.5%	-21.6%	-13.5%	-6.5%	0.1%	
21	**RD/GSDP**	**-3.4%**	**-2.6%**	**-2.0%**	**-3.1%**	**-2.0%**	**-1.0%**	**0.0%**	
22	**FD/GSDP**	**-4.2%**	**-3.5%**	**-2.9%**	**-4.6%**	**-3.4%**	**-3.0%**	**-2.8%**	
23	Debt Stock/GSDP	39.1%	38.6%	37.6%	37.8%	37.6%	36.5%	35.4%	
24	GSDP(in crore)	107054	118998	132739	148485	165000	185000	207000	12.0%
25	Nominal GSDP Growth Rate	11.5%	11.2%	11.5%	11.9%	11.1%	12.1%	11.9%	
26	Average Interest rate (Interest/mid-yr Debt)	9.11%	8.65%	8.75%	8.98%	8.72%	8.58%	8.53%	
27	Domar Gap (25 minus 26)	2.39%	2.50%	2.80%	2.88%	2.41%	3.54%	3.36%	