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**INDIA'S TWELFTH FINANCE
COMMISSION
A VIEW FROM KERALA**

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ABSTRACT

The focus of the paper is to review the Terms of Reference (TOR) of the Twelfth Finance Commission with special reference to Kerala. It also critically examines the emphasis on fiscal deficit reduction without paying attention to its quality and finds that this has led to the Centre and the States resorting to a softer option of cutting productive capital and necessary maintenance and social sector expenditure. This is likely to have adverse consequences on equitable growth and to impede the process of relieving the economy of structural constraints on growth. There is an urgent need for analysing the quality of fiscal consolidation instead of focusing merely on quantity of reduction of deficits as a proportion of Gross Domestic Product (GDP). The study hence suggests incorporating the concept of Quality of Fiscal Discipline.

It is found that there has been an enlargement of the scope of Finance Commissions [since the Eleventh Finance Commission (11th FC)] into mandates for recommending mechanisms for achieving macroeconomic balance, equitable growth, and suggestions for disinvestments and privatisation, while its role in the traditional area of grant devolution has been restricted to non-Plan grants only. In fact, the enlargement of the role in the traditional area of grant devolution would be more desirable.

There is sufficient scope for augmenting resource mobilisation from direct and indirect taxes at the Central level. Emphasis is to be placed on integrating services and manufacturing into a single CENVAT (Central Value Added Tax) and on direct taxes reform. The second generation tax reform should concentrate on States' tax administration and inter-State coordination prior to moving on to a State level VAT. There is need for a constitutional amendment to place service taxation in the Concurrent List and enable States to tax more services.

On the expenditure side, steep increases in items like wages and salaries and interest expenditure are unlikely in the near future. Hence maintenance and social sector expenditure should not be sacrificed. At the same time, efficiency in spending and cutting unproductive expenditure and leakages should be strictly monitored. A decentralised district level monitoring system for maintenance expenditure of capital assets is also suggested. The paper argues that bringing privatisation in the Terms of Reference of the Finance Commission seems avoidable. It is also felt that more effective time bound implementation of State Finance Commission Reports is needed. Along with devolution of funds, transfer of administrative functions is necessary for avoiding duplication of expenditure.

As for Kerala-specific issues, it is found that achievements on the human development front are not rewarded. Certain changes in the existing criteria (of the Eleventh Finance Commission) are hence suggested. Kerala's tax effort, though better than richer States like Punjab, is facing structural constraints. The fast expanding services sector is outside the tax net of the State. The tax-GDP ratio of Kerala showed a mild decline at 9.84 percent in the 1990s as compared to 10.29 percent in the 1980s despite a much higher growth rate of State Domestic Product, mainly because the State was not able to tax the dominant sector of the State Domestic Product, that is, the services sector.

Key words : finance commission, fiscal deficit, revenue mobilisation, devolution

JEL Classification : H77, H60, H20

Introduction

The scope of the paper is to briefly analyse the Terms of Reference of India's Twelfth Finance Commission with special emphasis on its impact on Kerala. To get a holistic perspective, we summarise the economic background for Central devolution of funds and the changing role of the Finance Commissions over time. In the course of the discussion, the concept of fiscal consolidation by targeting of deficits is critically examined and the necessity for targeting expenditure and revenue separately has been emphasised.

1. The Background

Role of Finance Commissions: A Brief Review

The Finance Commissions are constituted quinquennially as per constitutional requirements. India being a country of vast regional diversity and iniquitous distribution of natural resources, the ability to mobilise revenue by the States differs. But in a federal set up, principles of equalisation demands that citizens living in different geographical regions with differing capacity to raise own revenues, should be able to enjoy at least minimum amount of public services and the revenue needed to provide these public services should be devolved to all regions. The diversity is the main reason behind the approach of fiscal transfers to the States rather than the Centre providing the public services, except those with substantial economies of scale. These traditional principles of federal finance are the rationale behind the constitutional

provisions for Finance Commissions and the criteria for devolution of funds. During the course of time arguments for expanding the scope as well as the approach of the Finance Commissions beyond traditional principles of public finance have been advanced and we shall examine them in this paper.

The strategy during the 1950s was to embark on public sector-led planned economic development aimed at developing a socialistic pattern of society with the public sector attaining commanding heights of the economy. This led to the pre-eminence of the Planning Commission, though its role was not defined under the Constitution of India. The States fixed their Plan sizes and the Planning Commission gave them grants for financing the plans more than what they could afford with their own internal resources. Till 1969, the Plan assistance from the Centre was based on project basis. This was not problematic so long as the revenue requirements were taken care of by the Finance Commissions, in their totality, including what the execution of the Plans might call for. During the First and Second Plans, the award of the Finance Commissions took care of the revenue expenditure on account of the Plans as well. Under the Gadgil formula used for devolution of Plan assistance after 1969, grants were given to finance the current expenditure to maintain the assets created, in addition to loans, which were meant to finance capital expenditure. The subsequent Finance Commissions (except the ninth) took care of the needs of the States on non-Plan revenue account only (11th Finance Commission Report, para 2.40,p.13).

The practice of financing Plan revenue expenditure by borrowing (because the Plan revenue component is larger than 30 percent envisaged in the Gadgil formula), resulted in a higher non-Plan revenue expenditure after the plan period, thereby making the demands for devolution of taxes and grants stronger and making the task of the Finance Commissions that much tougher.

The Gadgil formula of the late 1960s divided the distribution of loans and grants of the Plan funds devolution in the ratio 70:30, implicitly assuming that revenue and capital expenditure components of the Plan will be in that ratio. The aim was to finance the revenue expenditure out of grants and capital expenditure out of loans. But subsequent experience showed that revenue expenditure component was much higher, probably at 55 percent, resulting in financing of plan revenue expenditure through borrowing and leaving a much higher level of non-plan revenue expenditure after the plan period [See Gurusurthi (2002), 11th FC Report p.13, for a discussion]¹. A substantial portion of Plan revenue expenditure is presently being met out of borrowing. What is needed is replacing the present 70:30 ratio with a more realistic one and leaves the entire grant devolution, Plan as well as non-Plan, to the Finance Commissions. This should be done in consultation with the Planning Commission for tackling the problem of later non-Plan revenue deficits at the stage of formulation of Plan size itself. For this, the constitution of the Finance Commission should coincide with the beginning of the Five Year Plans, for effective co ordination between Finance and Planning Commissions².

Though the scope of the Finance Commissions in the area of grant devolution has become narrower, albeit by a self-imposed restriction to devolve only grants to cover non-Plan revenue deficits, its scope is being enlarged at the same time by making it recommend measures for restructuring public finances of the Centre and the States with the Terms of Reference entering into realms of macro economic stability and equitable growth. Consider the following.

TOR No. 5 states

“The Commission shall review the state of finances of the Union and the States and suggest ways and means by which the Governments,

collectively and severally, may bring about a restructuring of the public finances restoring budgetary balance and maintain macroeconomic stability and debt reduction along with equitable growth”.

These are relatively new tasks [since the 11th FC)] assigned to the Finance Commissions, which look into the sharing of taxes and distributing grants-in-aid from the Centre to the States. Enlarging the scope of recommendations to restructure the public finances to achieve equitable growth, debt reduction and macro economic stability since the 11th FC, has added significance as they have coincided with the period of policies of economic liberalisation, especially since 1991.

With the Finance Commissions distributing grants-in-aid based on non-Plan revenue gap, (i.e. an assessment based on the growth rates applied by the Commission on the base year revenue and expenditure), there developed a tendency among the States to incur expenditure in excess of revenue and resort to borrowing. This was in the expectation that the resulting burden of committed expenditure and revenue gap would result in a higher devolution of grants-in-aid. In this process, States with no revenue deficit did not receive any grants-in-aid, while those with unbalanced budgets got away with their profligacy. This led to a rethinking that called for normative criteria, instead of actual (11th FC Report, Pp.15-16), namely what a State *should* practice instead of what it *actually* practices, given its resource base. This started with the Ninth Finance Commission. The inclusion of indicators of fiscal consolidation started with the 11th FC. Let us briefly examine them before proceeding to examine the TOR of 12th FC and the economic reasoning on the appropriateness of the summary fiscal indicators in the given national economic scenario and its implications for Kerala. Though the role of the Finance Commissions in the traditional area of grant devolution got restricted to only non-Plan grants, it is being given a new role as a facilitator of fiscal reforms at the State level.

Finance Commission and Fiscal Reforms: Highlights of the Eleventh Finance Commission Report

There were two points in the TOR of the 11th FC which were linked to fiscal consolidation

- 1) In TOR 4, the Commission was asked to suggest ways and means to restructure public finances of the Centre and the States for achieving budgetary balance and macro economic stability.³
- 2) Linking improvement in revenue budget to debt relief (for the specific formula, see Appendix XI.1, p.314 of the 11th FC Report).

How the mandate of the TOR 4 was carried out by the 11th FC is stated in Para 13.5 of the report (p.110).

“... The scheme envisages reduction of the combined fiscal deficit of the Centre and the States from 9.84 percent in 2000-01 to 6.5 percent in 2004-05. Revenue deficit will be reduced to 1 percent as against 6.77 percent at present. There will be no revenue deficit at the State level though the Centre may have a revenue deficit of 1 percent. Fiscal deficit of the Centre will decrease from 5.64 percent to 4.5 percent and that of the States from 4.71 percent to 2.5 percent. Capital expenditure of the Centre and the States (combined) should go up from 4.17 percent to 6.16 percent.”

In the 11th FC Report as well as the budget documents and the Fiscal Responsibility legislations of the Centre and the States like Kerala, the proportion of the summary indicators to the GDP and SDP has been emphasised and taken as indicators for achieving fiscal consolidation. Some comments on the impacts of this approach with respect to fiscal deficit as a prime indicator may be in order here.

2. Fiscal Deficit as a Proportion of GDP: A Reliable Measure of Fiscal Consolidation?

Much emphasis has been laid on the proportion of fiscal deficit to GDP/SDP as a summary measure of fiscal consolidation especially since 1991, when the Government of India officially brought in the concept of fiscal deficit⁴. Fiscal deficit as officially measured by the Government of India is the difference between aggregate disbursements excluding debt repayments and aggregate receipts net of debt receipts. One major and most palpable defect of this indicator is that fiscal deficit can be contained even while incurring more revenue deficit, by having a surplus in the capital account. In other words, overspending for current expenditures through borrowings at the cost of cutting down productive investment can lead to a smaller fiscal deficit. In fact, this has been happening throughout the 1990s in India.

Besides these complications, there have been other problems relating to definitional changes in fiscal deficit, which makes comparison over time of the ratio of fiscal deficit to GDP difficult. For example, borrowings from small savings have not been reflected in the Centre's fiscal deficit since 1999-2000, which makes the official fiscal deficit to GDP ratio incomparable with that of the previous years⁵.

Yet another method of reducing fiscal deficit is by treating disinvestments proceeds as receipts. This was already questioned by Gulati (1994), who visualised an extreme situation (stated as hypothetical) of government selling off equity in public sector undertakings but not utilising it for new public investments. In this case, the amounts raised by the government go to finance the current expenditure and it should actually be treated as raising the fiscal deficit rather than reducing it⁶.

Emphasis on reducing fiscal deficit as a proportion of GDP, as the Fiscal Responsibility and Budget Management Bill of the Centre and the States like Kerala and the 11th FC report suggest, can result in Centre and States resorting to the soft option of cutting capital investment expenditure rather than the downward-sticky revenue expenditure.⁷

Of late, the official agencies have also joined the academic critics in accepting that reduction of fiscal deficit alone is not a sufficient indicator of fiscal improvement, i.e. by recognising the significance of other indicators like revenue deficit and capital expenditure also in the list. But the pride of place is still occupied by fiscal deficit. Let us look at why this is so.

Fiscal deficit is an indicator of the borrowings by the government. The conventional argument is that higher borrowing by the government crowds out the available funds for private investment and also raises the interest rate thereby adversely affecting private investment. A higher fiscal deficit is also expected to spill over to external sector. This argument can be found in the *Eleventh Finance Commission Report* (Chapter III, para 3.7, p. 19), *Report on Currency and Finance 2001-02* of the RBI and Srinivasan (2002). In the prevailing economic situation, none of these is empirically tested in favour of the conventional arguments.⁸

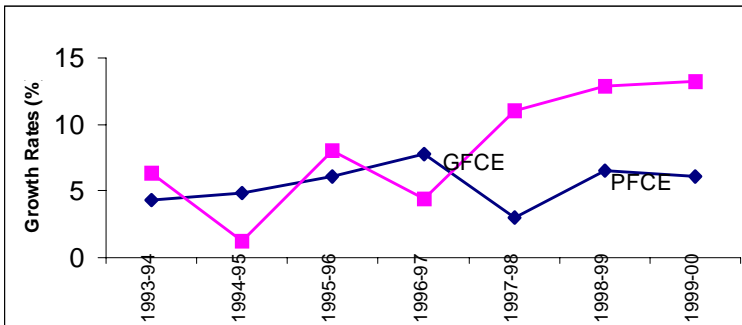
To state in a nutshell

- 1) In a state of deficient private demand (see Table 1) and low credit off-take, crowding out of funds for private investment does not occur as there is excess liquidity in the system as can be seen from banks investing in government securities in excess of statutory requirements;
- 2) In a situation of excess liquidity and also when interest rates are

partly administratively determined, a rise in interest as a direct consequence of government borrowings is not likely;

- 3) Empirical results on the relation between interest rate and private investment -although expected to be strong - are mixed in Indian as well as international contexts. Another strong determinant is private consumer demand, which in the latter half of the 1990s has been falling; and
- 4) Government spending as a sustaining factor of economic growth cannot be ignored.

Figure1: Growth Rates of Private and Government Final Consumption Expenditure 1993-94 to 1999-2000 (%)



Source: Computed from the data available in Hand Book of Statistics on Indian Economy, 2002, Reserve Bank of India.

Note: PFCE= Private Final Consumption Expenditure,
GFCE= Government Final Consumption Expenditure.

The growth rate of Gross Domestic Product has declined since the latter half of the 1990s and there is a clear association between this and the decline in growth of PFCE. Only GFCE has shown a rise. Going by the basic macro economic identity $Y=C+I+G$, we can see that had not the GFCE grown at this level, the total growth rate would have been still lower.⁹ This lends support to our proposition 4 made earlier.

Before concluding our comments on TOR 5, let us look at the merits of targeting another major deficit indicator, the revenue deficit.

Much of the revenue expenditure seems committed interest on past borrowings. This is the result of a conscious policy decision as a part of economic liberalisation that is putting an end to the earlier practice of automatic monetisation of the gap between total receipts and total expenditure by issue of ad hoc 91-day treasury bills at low rate of interest. This is described as financial repression of interest rates on government borrowing. Since April 1, 1997 the Central Government has been borrowing from Reserve Bank of India through Ways and Means advances and resorting to market borrowings at higher interest. This shift in the mode of financing the deficit is one major reason for the increasing interest payments in the revenue account.¹⁰ Given this situation, scope for reduction of revenue deficit is limited and can fall on expenditure on maintenance of capital assets, and at times on social sector expenditure also. This will have adverse consequences for the economy and hence the mere reduction of revenue deficit is also not always desirable, if it is achieved by cutting down expenditure having a significant positive impact on productivity of human capital and total factor productivity of the economy. Reduction of revenue deficit will be highly desirable if they are based on the following:

- 1) Reduction of the high cost debt through debt relief, a matter already taken cognisance of by the Tenth and Eleventh Finance Commissions;
- 2) Roll over of high cost debt by converting into new low interest bearing loans, as suggested in budget 2003;
- 3) Setting a target for salaries and wage bill and any increases in salaries by the Centre having a bearing on States to be implemented

only after consultation with the States. Before implementing Pay Commission reports, it should be mandatory that it should be approved by a representative committee of State Chief Ministers; and

- 4) Political consensus on levy of user charges on people who have the ability to pay.

To put it briefly, though incurring of revenue deficit on an ongoing basis is definitely a sign of imbalance, its reduction and phased elimination is necessary but the ways through which it is achieved will have impacts on achieving equitable growth as stated in Terms of Reference 5. We have attempted in the foregoing paragraphs to point out that reducing deficits, fiscal as well as revenue, should not be seen *prima facie* as a sign of improvement of fiscal health. More important is how it is achieved or what we may call “Quality of Fiscal Discipline (QFD)”. We therefore attempt to define QFD as follows:

Fiscal adjustment can be described to be of high quality if

- a) It is not achieved by reduction of productive capital expenditure, especially in non-tradable infrastructure investment, essential for relieving the structural constraints to growth (e.g. transport, water control, electricity, air and sea ports and so on);
- b) It is achieved by more revenue mobilisation without disturbing the stability of tax system, i.e. frequent changes in rates, levy of surcharges as a revenue gap filling measure, etc. Phased reduction in tax arrears by collection and expeditious disposal of appeals should be taken as a positive measure. In short, tax base widening should be favoured to tax deepening;
- c) Increasing tax-GDP ratio especially from under- taxed sectors with high potential like real estate and construction sectors;

- d) Phased reduction of tax expenditure, that is cutting down of loss of revenue through various selective exemptions and deductions in the tax statute, as pointed out by the Kelkar Task Force;¹¹
- e) It is achieved by not cutting the maintenance expenditure for upkeep of the capital assets created and by putting in place an effective mechanism for monitoring this expenditure;
- f) Maintenance of social sector expenditure, but with levy of user charges from those with ability to pay; and
- g) Progressive reduction of non-merit subsidies.

A composite index for QFD needs to be formulated¹². This will give weight to quality of reduction of deficit instead of merely a quantitative reduction. This is essential if principles of devolution and resource mobilisation should lead to achievement of equitable growth, which has been incorporated as a new terms of reference in the Twelfth Finance Commission. This being a very important aim, it is felt that the norms of devolution of taxes and grants-in-aid should radically depart from what has been followed hitherto.

When quality of expenditure and revenue mobilisation is closely monitored and quality improvement achieved, quantitative reduction will follow. A mere reduction of aggregate indicators like fiscal deficit may mask the underlying fiscal imbalances and means of achieving the reduction in deficit. Balakrishnan (1997) distinguishes between fiscal responsibility and fiscal correction. Fiscal responsibility must be insisted upon as an absolute criterion of good government, while fiscal correction is interpreted as a reduction of fiscal deficit, no matter how it is achieved and what the consequences are and it may not always amount to responsible behaviour on the part of the government.¹³

We suggest that in measuring the quantity reduction in indicators like fiscal deficits, these quality factors should have positive and negative weights so that we get a quality-adjusted reduction of deficits. Alternatively, a weighted average of these factors itself can be treated as a measure of fiscal discipline for devolution of grants-in-aid.

3. Resource Mobilisation by the Central Government: TOR 6 (i)

Resources of the Central Government for the next five years commencing from April 1 2005, on the basis of levels of taxation and non-tax revenues likely to be reached at the end of 2003-04.

Though this paper focuses on the impacts of the Terms of Reference on the States, especially Kerala, it is necessary to analyse this TOR on resource mobilisation of the Centre as the demand of the States for increased Central share ultimately hinges on the size of the Centre's kitty, which is the direct consequence of the efforts and methods of resource mobilisation by the Centre and the commitments in Central expenditure. So analysing the position of the States without considering resource mobilisation by the Centre will not present a holistic picture. Hence, we proceed to examine the aspect of the problems and prospects of resource mobilisation and trends in expenditure of the Central Government.

As far as the resources of the Central Government are concerned, excise duty is still the most important source of revenue, with customs duty revenue declining and presently equalling the corporate tax followed by personal income tax. The conventional wisdom and experience of western countries show that as a country reaches higher stages of development, the proportion of direct taxes in total revenue rises at the cost of commodity and consumption based taxes. In the decade of the 1990s, there was indeed a buoyancy of direct taxes, but much is left desired as a perusal of the report of the Kelkar Task Force on indirect and direct taxes reveals.

In view of the burgeoning interest payment burden and other committed expenditures, the Central Government is also faced with the necessity of augmenting revenues. Let us look at a few areas of administrative and economic problems of resource mobilisation by the Centre and how they are interlinked with the States' finances through tax devolution and grants-in-aid. The Economic Survey 2003 pointed out that *while the States' own tax revenues registered a marginal improvement during the period 1990-91 to 2001-02, the shortfall in growth of central revenue has constrained the revenue receipts of the States* (Economic Times, February 28, 2003: 8)

Direct Taxes Front

The major direct taxes of the Central Government are 1) corporate tax and 2) personal income tax. Among other direct taxes only wealth tax has been retained. Taxes like Estate Duty, Gift Tax, and Interest Tax have been deleted over the period of time (the latter two during the 1990s and the scope of wealth tax considerably reduced by raising the exemption limit to Rupees 15 lakhs and items of levy restricted). Previously 85 percent of the personal income tax was shared with the States while corporate tax was not shared. The Eightieth Constitution amendment changed it to a percentage of the pool of the central taxes. Let us look at the trend of the direct tax collections over time especially during the 1990s.

Table1: Taxes as a Proportion of GDP

| Tax | 1975-80 | 1985-90 | 1991-92 | 1992-93 | 1993-94 | 1999-00 |
|---------------------|---------|---------|---------|---------|---------|---------|
| Personal Income Tax | 1.24 | 1.03 | 1.09 | 1.12 | 1.21 | 1.38 |
| Corporate Tax | 1.19 | 1.07 | 1.27 | 1.27 | 1.34 | 1.55 |
| Union Excise Duty | 5.00 | 4.89 | 4.56 | 4.39 | 4.04 | 3.26 |
| Customs Duty | 2.12 | 3.94 | 3.61 | 3.38 | 2.86 | 2.47 |

Source: [Bagchi (1997), 11th FC Report, p.27]

Personal income tax as a proportion GDP has been almost stagnant and is below the level of what it was during 1950-51 (1.43 percent of GDP), at the close of the century. When the economic growth rate during the fifty-year period has gone up significantly, the personal income tax collection has not kept up with it. Kelkar Task Force had taken note of the necessity for direct taxes reforms. While it is true that direct taxes have shown more buoyancy than indirect taxes, augmenting revenues from these is still possible.

Though tax administrative reforms are important, institutional mechanisms of Centre-State governments exchanging information is necessary.¹⁴ Corporate tax and personal income tax trends are linked to economic growth and increase in incomes. It is suggested that along with the tax administrative reforms initiated to enlarge the information base to check tax evasion, elimination of complicated exemptions and deductions for computation of corporate and personal income taxation will result in rise in effective tax rate.

Indirect Taxes Front

As per the budget 2003, 58 percent of the total tax revenue is from indirect taxes, with union excise duty contributing to 38 percent and customs 20 percent. We can reasonably expect customs duty rates to stabilise, after a continuous fall in the 1990s as part of the import liberalisation strategy. The peak duty has almost come down from 110 percent in the 1980s to 25 percent in the budget 2003. With the duty rates stabilising, revenue fall from customs duty may not happen further. (Though this is also linked to economic growth and import elasticity of rising incomes). But customs revenue cannot be that important in the future as it used to be in the past as rate increase above certain levels will not be possible due to WTO stipulations. The area of concentration in indirect taxes is to be on union excise. The revenues from union excise

duties as a percentage of GDP is also stagnating and even showing a mild decline. This can be partly attributed to slowdown in the growth rate of manufacturing sector output in the second half of the 1990s. Yet another strong reason could be exclusion of many services from taxation.¹⁵ Since many services go into the pre-manufacturing and post-manufacturing stages, a Value Added Tax need to consider services and manufacturing together.

The States also presently have the power to levy tax on purchase and sale of goods. At the second stage, Value Added Tax (VAT) including services should be introduced in all States simultaneously. Presently, the State level implementation of VAT has been postponed. There has been political as well as fiscal interest-based opposition to VAT.

We do not intend to go into the details of merits and demerits of a VAT. But one thing is very clear. Present tax competition by the State governments is unsustainable from the revenue and fiscal sustainability of State governments. Hence emphasis on implementation of VAT at the State level also needs to be considered as a revenue augmenting measure. Shome (2002) has discussed elaborately the administrative and other problems when attempting to implement VAT at the State level. The inclusion of inter-State trade in VAT is one issue and all States simultaneously agreeing to implement VAT are even more important, else the system will fail. There can also be administrative cost of tracking down evasion by producing bogus invoices to claim false credit of input taxes, at least in the beginning till a database of information and inter-State linkages of information sharing are established. Given the State of tax collection machinery these changes can take considerable time and require attitudinal changes for a new working environment where tackling evasion is by utilisation and sharing of information and not by policing methods. Still an eventual movement towards a Value

Added Tax first at Central and then at the State level by bringing services substantially into tax net is an aim to be strived for in the larger interests of non-cascading resource mobilisation. But at the State level substantial efforts at inter-State coordination and tax administrative reforms have to precede the movement towards a VAT, else it can result in more loss of revenue through fraudulent claims for tax credit.

In sum, direct taxation and commodity and service taxation require streamlining as well as reforms, as the earlier practice of reliance on customs duty as a major source of revenue may not be possible in the future due to the liberalisation of trade.

4. Expenditure of the Central Government: TOR 6(ii)

“The demands on the resources of the Central Government, in particular, on account of expenditure on civil administration, defence, internal and border security, debt servicing and other committed expenditure liabilities.”

Since the early 1980s the Central Government has been incurring revenue deficit. But States had revenue surplus/balance almost till the late 1980s. It is commonly hypothesised that States' revenue accounts went into deficits with the implementation of the Fifth Pay Commission Award, which was rather imposed by the States which had to accept it as a *fait accompli* as the decision to implement it was taken by the Centre unilaterally.¹⁶ Considering the overall picture of the States, it is worth examining whether the implementation of the Fifth Pay Commission award was the starting point of the explosion of wages and salaries bill or was the culmination of a gradual increase in size of the State bureaucracy over a period of time. Virmani (1990) found that in public consumption, the ratio of wages and salaries to income grew at a faster rate than that of commodities to income during the 1970s and 1980s.

Real government wage rates have increased since 1973 and there has been what is described as ‘Grade Inflation’, that is a shift in the structure towards higher grades. The State governments’ real wage bill was the highest among the three levels of the government. The growth of employee compensation at the State government level has been faster than that in the Central Government. The period 1983 was followed by revision of salary by the Fourth and Fifth Pay Commissions. The point sought to be emphasised here is that even prior to the revisions of pay by these two Pay Commissions, there has been a faster growth rate of employee compensation at the State government level. The signs of unsustainability were there even before. The interest rates in the Centre’s expenditure shot up also due to the decision to change the mode of financing deficits from automatic monetisation. States never had that facility in a federal set up and had been facing a harder budget constraint than the Centre all along. Hence the deficits, especially revenue deficits, create the problem of debt sustainability more for the States.

In the near future, it is not likely to expect a rise in wages and salaries as it happened after the Fifth Pay Commission award. The Eleventh Finance Commission has made certain recommendations in this regard (para 3.5, Pp.35-36). The important ones are (a) not to appoint Pay Commissions as a matter of routine when there is neutralisation for increase in prices for all categories of employees, and (b) consultation with States before implementing recommendations of Pay Commissions. Yet another reason is that the bargaining power of the organised labour appears to have received a set back following the inability to meet with success in agitations for retaining certain existing (and long enjoyed) monetary benefits, which have been taken away by various State governments citing fiscal crisis as a reason (government employees strike in Kerala during February 2002 and in Tamil Nadu in July 2003). The interest payment burden is also likely to decline as the Centre has

already announced rescheduling of previous high cost debt into low cost fresh loans. The low interest rate regime may not be reversed in the near future.

The optimistic expectation on the current expenditure side of the Centre as well as the States is that the committed expenditure will not increase disproportionately to crowd out productive expenditure.¹⁷ The need is to monitor and check any wasteful and unproductive expenditure while not compromising on maintenance and social sector expenditure and take measures for realising resource mobilisation potential, there by ensuring a quality of fiscal balance and not a mere reduction in ratios of deficit to output without caring for the means by which it was achieved. This is important for both Central and State Governments.

Maintenance Expenditure and it's Monitoring: TOR 6 (vi)

“The expenditure on the non-salary component of maintenance and upkeep of capital assets and non-wage related maintenance expenditure on plan schemes to be completed by 31st March 2005 and the norms on the basis of which specific amounts are recommended for the maintenance of capital assets and the manner of monitoring such expenditure.”

There is a general agreement that capital investment expenditure is productive and current expenditure is not.¹⁸ Equally important is the aspect of keeping capital assets created in a running condition, else capital investment becomes capital waste with the assets not functioning during their productive life period. Hence the emphasis placed on maintenance expenditure by the 11th FC and the 12th FC is well deserved. Since maintenance expenditure is revenue and non-Plan, in the eagerness to cut deficits and show surpluses or low deficits in these accounts, the axe often falls on this expenditure. Expenditure like interest payments

and other expenditure such as subsidies championed by interest groups are often spared. It is hoped that the specific attention given to this expenditure by the Finance Commissions will help to curb this tendency.

Maintenance expenditure as a proportion of revenue expenditure in Kerala was approximately 3 percent till 1999-2000 and came down to 2.3 percent in 2000-01 and 2001-02 (Economic Review, 2002: 18). The trend of decline in maintenance expenditure was observed by the Tenth and Eleventh Finance Commissions and the latter (para 5.56, p.52) mentioned the lack of transparency in the expenditure accounts of the State governments regarding maintenance expenditure. The Tenth Finance Commission recommended the constitution of a high powered committee of senior officials chaired by the Chief Secretary for quarterly monitoring of the utilisation of funds to ensure that the funds allocated are not diverted to other areas. The 11th FC has observed that nothing much has been done in this regard and expenditure levels still continue to be far below the amounts provided by the 10th FC. As stated earlier, one reason attributable to this is the eagerness to control the non-Plan revenue expenditure as reduction of revenue deficit achieved by whatever means is rewarded.

We suggest that the monitoring mechanism be decentralised to the district level by including peoples' representatives and heads of local bodies, rather than at the level of the top State bureaucracy. This may ensure better attention as a result of the inclusion of prominent citizens and local bodies.

Pricing of Public Utilities and Privatisation:TOR 6(vii)

“The need for ensuring the commercial viability of irrigation projects, power projects, departmental undertakings, public sector enterprises etc. in the States through various means including adjustment of user charges and relinquishing of non-priority enterprises through privatisation or disinvestments.”

This has wide ramifications and presupposes certain value judgements. While there can be no dispute in collecting user charges for services from those with the ability to pay and preventing the flow of subsidies to the unintended [like camouflaging of unmetered supply of electricity in many States as free power supplied to farmers] it has to be noted that higher cost of operational inefficiency should not be transferred to the customer. To state in other words, many of these service providers should undergo efficiency-oriented reforms, which does not necessarily mean privatisation and inducing competition. Take the example of power sector. It is a case of natural monopoly and inducing competition may involve welfare losses (Kannan and Pillai 2002). Reforms can also be carried out by retaining public ownership, provided managerial autonomy, freedom of decision-making and performance based incentives are introduced in public enterprises. In fact, public investment in infrastructure and non- tradable has a crowding-in effect on private investment and private ownership in these areas has not been success stories.

Withdrawing from non-priority areas is also mentioned. The word priority is heavily loaded and can differ depending on differences in perspectives. Assuming that it is meant to refer to public production of private goods, the motive for privatisation and disinvestments should be clear. It should not be for meeting the fiscal deficit target. The transparency in sale is another issue. Though we do not propose to enter into the wider issue of privatisation of public enterprises here, we cannot avoid discussing why this issue should be linked to constitutional devolution of taxes and grants-in-aid. This gives rise to the reasonable presumption that disinvestments proceeds are expected to enter as receipts and thereby reducing of deficits. This sort of deficit reduction does not constitute a quality-based reduction for reasons discussed earlier. The option of privatisation or otherwise, could have been left to the

respective governments. Here privatisation is implicitly treated as the only answer to the problems of the public sector undertakings and devolutions of taxes and grants-in-aid as per constitutional requirements are being attempted to be linked to this. This, if made a condition of transfer of grants-in-aid, it is likely to affect States like Kerala where privatisation of public undertakings is a politically sensitive issue and needs to be undertaken with caution after exploring other options and perhaps as a last resort¹⁹.

5. Devolution of Funds to Local Bodies-TOR 4 (iii)

“The measures needed to augment the Consolidated Fund of a State to supplement the resources of the Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.”

Though the appointment of the State Finance Commissions (SFC) has been made a constitutional requirement, they have so far not been synchronised with the appointment of the Central Finance Commission’s Report. It needs to be stipulated that the State Finance Commission’s report should be laid within two years in the State Assembly and recommendations should be acted upon within six months’ of submission. The devolution of grants from the Centre to the States in fourth and fifth years of the quinquennial period should be conditional on States implementing the SFC recommendations.

Along with expenditure devolution, control over administrative machinery should also be given to the local bodies, else it will result in duplication of bureaucratic apparatus.

Panchayats’ and Municipalities’ revenue enhancing powers, though limited, should be utilised more effectively in the levy of existing professional and building taxes. Many non-monetary perquisites, which

escape professional taxation, should be evaluated and taxed. This will not amount to double taxation, as profession tax is deductible in computation of Central Income tax.

Building valuation guidelines for levy of building tax need periodic up gradation and should be realistic so that litigation free revenue can be mobilised

There is a suggestion for levy of user charges, which will help local bodies in floating municipal bonds for mobilising funds through the market routes instead of burdening the State government with debt guarantee and going for the soft option of floating SLR bonds (Reddy 1997). The social equity implications of this will have to be thought through.

Some of the service taxes (now selectively taxed by the Centre and to a very limited extent by the States), at least those not having inter-State ramifications, if assigned to States can augment the Consolidated Funds of the States and a part of this can be devolved to panchayats as per recommendations of the SFCs.

It needs to be considered whether the Central Finance Commission should have the State devolution to the local bodies as a Terms of Reference at all. With some changes in mechanism, i.e. by synchronising the constitution of State Finance Commissions (SFCs) and the Central Finance Commissions, making the mode of implementation of recommendations on devolution of taxes and grants by the State to the local bodies by the SFCs on the same pattern as the mechanism of implementation of the Central Finance commission's recommendations on devolution, the matter can be taken out of the purview of the Central Finance Commission. But in the initial stages, till the systems of SFCs become set, Central Finance Commissions may make recommendations.

But the devolution of funds should be based solely on transfer of funds and functions to the local bodies and not based on criteria devolved by the 11th FC, which have been the subject of critical comments. If criteria like population is given 40 percent weight as done by the 11th FC, States, which have been neglecting the process of decentralisation, will benefit, whereas States like Kerala, which have pioneered decentralisation much before it became a Constitutional requirement will suffer.

We have already discussed TOR 8 by commenting on the importance of the means of achieving fiscal consolidation. We will discuss TOR 9 with reference to the Kerala's example.

6. Human Development and Investment Climate: TOR 9

The Commission may, after making an assessment of the debt position of the States as on 31st March 2004, suggest such corrective measures, as are deemed necessary, consistent with macro-economic stability and debt sustainability. Such measure recommended will give weightage of the performance of the States in the fields of human development and investment climate.

When a region (State in this case) achieves a high level of human development, it will be reflected in a higher government spending. Though human capital formation has been recognised as a total factor input in growth accounting exercises, it is to be noted that government spending in this area will not reap contemporaneous economic returns and will essentially involve spending in areas, which are classified as 'revenue expenditure' and 'non-plan revenue expenditure'. When educational facility is extended to all economic groups, instant cost recovery will be low, though in the medium term and long-term, it improves the productivity of human capital, which can have

considerable positive externalities. We would argue that the remittances from Gulf, made possible by large-scale migration in the previous decades, was a consequence of the minimum level of education provided to all by the State Government. While Kerala benefited by this international labour migration, it needs to be recognised that the country as a whole also benefited in terms of significant flows of foreign exchange for a considerable period of time (Recall the speech of Dr. Manmohan Singh, the then Union Finance Minister in Parliament 1991-92). Even inter-State migration and comparative advantage in the job market is due to the better quality of human capital formation. Due to a number of factors that are beyond the control of the State, the regional economy of Kerala could not find private and public capital investment commensurate with its level of human development. It is sought to be pointed out that in the face of mobility of educated labour as a factor of production, and regional economies being open economies, even the medium-term and long-term benefits of spending on the social sectors like education and health may not be entirely reaped by them. In short, the spillover effects of spending for the formation of a quality human capital by a State like Kerala over a period of time may have been enjoyed by other regions in the country.

Investment climate has been mistakenly associated with providing competitive fiscal incentives by the States. This especially so, when the licensing system has by and large been scrapped and the States compete for private investment. Though this may be an important factor in attracting investment it could result in erosion of the tax base of the States. Productive and educated human capital is also an important factor in determining the investment climate of a State.

As regards the debt position, States whose debt-SDP ratio is less than all States average or whose debt-SDP ratio has not had a significant growth over a period of, say, twenty years may be considered for debt

relief, especially if the States have a higher than all States component of high cost debt (e.g. Small Savings, Provident Funds and from other items in the Public Account). Other criteria like tax effort may also be considered while granting debt relief.

7. Kerala and Central Devolution of Funds

The Terms of Reference of Twelfth Finance Commission: Their Likely Impact on Kerala

According to the Kerala Government, the Central devolution to Kerala decreased after the implementation of the Eleventh Finance Commission's recommendations. The following table illustrates this.

Table 2: Summary of impact of 11th FC Recommendations on Kerala's Share (in %)

| | Population Share | Share of Taxes | Share of Grants | Share of Total Transfers | Estimated loss over that of the Tenth Finance Commission Recommendations |
|-------------|------------------|----------------|-----------------|--------------------------|--|
| Tenth FC | 3.438 | 3.598 | 2.489 | 3.407 | |
| Eleventh FC | 3.490 | 3.057 | 1.387 | 2.832 | Rs.3664 Crores |

Source: Economic Review, Kerala 2002, Table –2.25 p.18

The reason mentioned in the Economic Review, 2002 of the Government of Kerala, for this loss is the change in formula for devolution of funds by the 11th FC. Let us very briefly examine this.

Instead of distinguishing between shareable and non-shareable taxes, a share of 29 percent of net²⁰ proceeds of central taxes and duties was recommended to be distributed among all the States, with an additional 1.5 percent of net proceeds of central taxes and duties in a

year was supposed to be distributed to the States which did not levy sales tax on sugar, textiles and tobacco during that year. The criteria of the devolution of taxes are given in Table 3.

Table 3: 11th FC Criteria for Devolution of Taxes (Percent)

| Criterion | Relative Weights | |
|--------------------------|------------------|-------------|
| | Tenth FC | Eleventh FC |
| Population | 20 | 10 |
| Income (Distance Method) | 60 | 62.5 |
| Area | 5 | 7.5 |
| Index of Infrastructure | 5 | 7.5 |
| Tax Effort | 10 | 5.0 |
| Fiscal Discipline | --- | 7.5 |

Source: 11th FC Report, Table 6.2, p. 58

As can be seen from the Table 2, the loss is mainly on account of declining share of grants-in-aid. Under Article 275 (1) of the Indian Constitution, the Finance Commission devolves grants-in-aid to States, which have a deficit in non-plan revenue account after devolution of Central taxes. Since Kerala has surplus, according to Finance Commission's estimates in non-plan revenue account after devolution of Central taxes, it has not been given any grants-in-aid under Article 275 (1).

Before examining how each criterion will affect Kerala, let us make a mention about the logic behind transfer of funds from the Centre to the States.

- 1) The State's expenditure obligations far exceed their share in overall revenue of the Centre and the States;

- 2) In a federal set up, richer States, in view of their higher revenue capacity can provide better standards of public service than their poorer counterparts. To offset this disadvantage, equalising transfers are necessary; and
- 3) The transfers should not only offset fiscal disadvantages from a lower revenue capacity but also the higher unit cost of providing public services [See Rao (1997) for a discussion on these points].

It is because of these traditional principles that population, the distance of the State's per capita income from the highest, etc. became the criteria for devolution of central funds. Over a period of time, additional indicators like tax effort, fiscal discipline, index of infrastructure also became the criteria, perhaps with the aim of rewarding States, which perform well in these areas. With vast regional (both inter-State and intra-State) inequalities, it can be argued that the time has not come to discard the indicators like population, distance method, area etc. However, it is to be recognised that some modifications and additional indicators are required to reward States which have achieved a high level of human developments-increasingly being recognised as the overarching goal of economic development, among which Kerala is of course the front ranking State in India. The modification will become necessary in view of the Terms of Reference 9 of the Twelfth Finance Commission, which stresses on human development and investment climate. Here the achievements in human development and investment climate are sought to be linked to macroeconomic stability and debt sustainability (See Paragraph 7 for a discussion). Let us briefly discuss the criteria used by the Eleventh Finance Commission for devolution of funds and need for changes.

(a) Population: This indicator needs modification. Kerala had suggested before the 11th FC for inclusion of criteria like proportion of population above 60 years and density of population. It is suggested

that fifty percent of the devolution based on population criterion should be based on weighted average of the indicators of achievements like a low level of Total Fertility Rate (below the National Average), life expectancy (above the National Average) and a measure of health care (Coverage of Population by Primary Health Care Centres). To start with the devolution based on these indicators can be fifty percent of the weight for the Population criterion, but should be progressively increased and over a period of time replacing population as a criterion for devolution of funds. This approach will reward the States striving to attain a faster demographic transition as well as enhance the quality of population.

Given the national objective of reducing the population growth rate, this criterion would go against the performing States like Kerala, Tamil Nadu and Andhra Pradesh with substantial achievements in reducing population growth. The rigour of the population criterion will of course be felt less by the achievers since the Terms of Reference takes the population based on 1971 census. Nevertheless the quality of population achieved through a demographic transition need to be explicitly brought into the criteria for tax devolution to reward the achievers.

b) Distance Criterion: This is in accordance with the traditional principles of fiscal federalism. Kerala may not benefit much from the present distance criterion. The 11th FC took the distance from the average of the per capita incomes of Punjab, Maharashtra and Goa. Kerala is in the middle-income group of States. Kerala's position is 7. This criterion was given weightage of 62.5 percent in the Eleventh Finance Commission. Since per capita income is the basis for this criterion, there is implicit weight given to population and this indicator will not benefit States like Kerala.

c) Area: This criterion is aimed at taking care of high unit cost of providing public goods and incurring of heavy administrative infrastructure in large States with sparse density of population. This criterion is not a favourable one to Kerala with a small percentage of area but with a high population density. A dynamic fiscal situation requires that this criterion eventually needs to be phased out. The infrastructure projects once established will have low marginal costs and financing the pricing of utilities have to be through appropriate tax and non-tax revenues. Specific handicaps in infrastructure will have to overcome by project-specific loans and grants. The Eleventh Finance Commission raised the share of this criterion from 5 percent by the Tenth Finance Commission to 7.5 percent. It is suggested that the share be reverted to 5 percent.

d) Index of Infrastructure: This index takes care of the physical infrastructure. Since human capital has come to be recognised as a very important factor in attracting physical capital,²¹ it should be given appropriate weight in the construction of index of infrastructure. The maintenance infrastructure requires expenditure and consequent stress on the fiscal situation. States with high achievement in infrastructure index needs to be given higher up gradation and maintenance grants also, as an incentive for achievement and as a necessity for maintaining and improving quality of infrastructure. In fact, there is a case for considering giving special up gradation grants for States, which take efforts to achieve a higher infrastructure index. It should be noted that Kerala has a higher infrastructure index and ranks sixth (by CMIE Infrastructure index) among the Indian States and Union Territories.

e) Tax Effort: This is now measured by weighted tax-GDP ratio, i.e. the ratio of per capita own tax revenue of a State to its per capita income weighted by the inverse of per capita income. The 11th FC reduced

this weight by 50 percent. The intention of the measure is to reward poorer States, which exploited its tax base as much as a richer State. Another measure suggested by Kalra (2001) is also worth considering and it will be beneficial to Kerala for its tax effort. This measure is the ratio of the Effort Relative to Capacity Relative. Capacity Relative (CR) is computed as the ratio of the per capita income of the State to 14 representative States, whereas Effort Relative (ER) is the ratio of the per capita tax to the average per capita tax of the 14 representative States. In the devolution of funds based on tax effort the States with $ER > CR$ should get positive incentives. A portion of the devolution should be set apart for the States on the criterion of $ER > CR$, whereas States with $ER < CR$ will not get any share from this part. Kerala has had $ER > CR$ throughout the three decadal periods of the 1970s, 1980s and the 1990s, whereas richer States like Gujarat, Haryana, Maharashtra, Punjab and West Bengal had $ER < CR$ in 1996-97 (see Appendix 1 for full details of the results of the measure). The weightage of this criterion reduced by the 11th FC should be restored to the previous level of 10 percent or at least to 7.5 percent (by adjusting the reduction for the Area criterion).

f) Fiscal Discipline: According to the recommendations of the 11th FC, the improvement in the ratio of revenue receipts to revenue expenditure from the base period (1990-91 to 1992-93) to the reference period (1996-97 to 1998-99) and improvement of a State's performance is compared with the all States' performance. As stated in the 11th FC Report (para 6.33 p.58) this can be achieved by either raising revenue receipts or reducing revenue expenditure. As pointed out earlier in our discussion, this measure needs to be modified by including incentives and disincentives for quality of revenue expenditure reduction since equitable growth is part of TOR of the 12th FC and for that social sector spending by the government is very important. Appropriate negative and positive weights for compression and expansion of this expenditure

may be introduced based on, what we have proposed here, the Quality of Fiscal Discipline (QFD).

Traditional Devolution Criteria and Kerala

Kerala does not stand to benefit from the traditional criteria of fiscal federalism, i.e. backwardness, population, area etc. But in a dynamic situation the conventional criteria of fiscal devolution should be harmonized with the second generation problems of the States like Kerala, which have achieved a high level of human development, though at a fiscal cost. The provision of education and health care by the State had its own fiscal implications. Social and Community services expenditure are highly revenue expenditure-intensive. According to estimations by the Eleventh Finance Commission Kerala has been taking above average tax effort. It is the second-generation problems that are not getting their due attention in the devolution of Central funds to Kerala. To illustrate a few

- 1) High level of educated unemployed,
- 2) Fiscal strains affecting State-sponsored health and welfare schemes which do have a positive impact on human capital,
- 3) Deteriorating quality in higher education, and
- 4) High dependence on services sector, which is untaxable at the State level.

The recovery of user charges from social and community services like education has become very difficult due to emergence of strong demand groups like students and teachers' organisations²². Higher education in the State is almost free and any move to impose user charges is being opposed by student organisations of all political colours. Traders' resistance to sales tax enforcement machinery is very strong. The political combinations in the State have not been able to

strategically handle interest groups and make a break through in mobilisation of resources. With stagnating revenues and high expenditure commitments, the State's fiscal situation has become precarious, more so with a substantial portion of high cost debt, though the trend in debt-SDP ratio has not been rising. But it has to be taken note of that despite all these region-specific political economic constraints; Kerala has been doing better than other States as far as revenue mobilisation is concerned. We shall examine some of the aspects of the State's finances in the following paragraphs.

Trends in the Sectoral Growth Patterns in Kerala - With Emphasis on Tax Base

That the Kerala economy is a service sector led one is quite well known. In 2000-01, almost 56 percent of the State Net Domestic Product emanated from the Services sector. The Table below shows the sectoral composition (Sectoral SDPs as a proportion of State SDP) of the Kerala economy for the twenty-two year period from 1980-81 to 2001-02.

Table 4: Decadal Sectoral Shares (%) in Kerala's SDP at constant prices (1993-94)

| Year | Primary | Secondary | Tertiary |
|---------|---------|-----------|----------|
| 1980-81 | 37 | 20 | 43 |
| 1990-91 | 34 | 19 | 47 |
| 2000-01 | 25 | 19 | 55 |
| 2001-02 | 25 | 20 | 56 |

Source: Computed from the data from the site circonindia.com and Economic Review

Within the service sector, changes have taken place in the sub-sectoral shares (sub-sectoral SDP as a proportion of Sectoral SDP). The

sub-sector Trade, Hotels and Restaurants, which occupied a 51 percent share of Tertiary SDP, has come down to 35 percent and much of this fall in share has been taken by the rising Transport, Storage and Communication sub-sector. The growth rate of real estate sector is stagnant and that of other services (which includes community and personal services) is also coming down. Table 5 illustrates this.

Table 5: Decadal Sub-Sectoral Shares in the Tertiary Sector (%): 1980-81 to 1998-99.

| Year | Transport, Storage & Communications | Trade Hotels & Restaurants | Banking and Insurance | Real Estate | Public Administration | Other Services |
|---------|-------------------------------------|----------------------------|-----------------------|-------------|-----------------------|----------------|
| 1980-81 | 6 | 51 | 4 | 8 | 8 | 22 |
| 1990-91 | 9 | 42 | 10 | 10 | 11 | 18 |
| 1998-99 | 19 | 35 | 14 | 10 | 8 | 15 |

Source: Computed from data downloaded from circonindia.com and Economic Review, Kerala

With the secondary sector (a major component of which is the manufacturing sector) almost stagnating at 20 percent of State Net Domestic Product, and trade hotels and restaurants share coming down, the tax base for the present dominant taxes, like sales taxes, tax on hotels etc. is coming down.

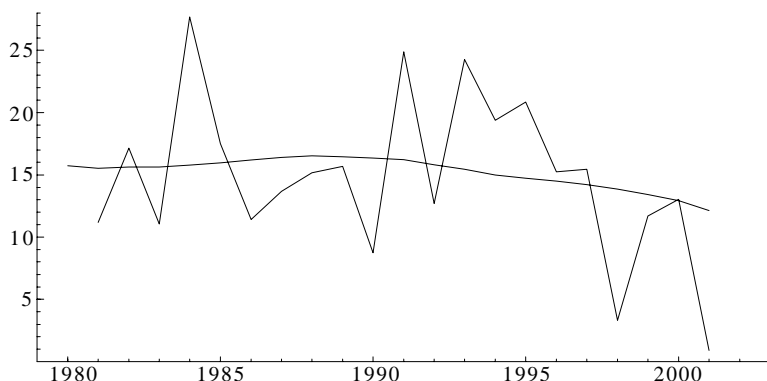
The fast growing sector appears to be transport, storage and communications. Our emphasis should be on service taxation of this sub-sector. The problem, which arises here, is that communication has always been an exclusive Central subject and it will be difficult to argue for states to get the power to tax these services. One suggestion that can be made is that the tax collected on telephone services should

be devolved to the states on the basis of tele-density²³. (This of course will require separate norms for devolution of the taxation of certain select services by the Central Government. This can be thought of till a Constitutional amendment putting services in the Concurrent list is made and State's authority regarding taxation of services clearly delineated)²⁴.

Trends in Revenue Receipts, Tax Receipts and Public Debt

Tax receipts as a proportion of revenue receipts went up from 57 percent during 1980-81 to 1990-91 to 70 percent in 1990-91 to 2001-02. Interest payments rose from 7.61 percent in 1980-81 to 25.68 percent of the revenue receipts in 2001-02. Public debt as a proportion of SDP during the same period increased from 27.32 to 38.72.²⁵ Let us examine the trend in tax receipts for the twenty-year period. Picture 2 shows the actual and trend (with cyclical and irregular fluctuations removed) of the tax revenue for the period 1981-82 to 2001-02. The structural growth path of the tax revenues showed a downward movement throughout the 1990s, indicating clearly that there are long-term constraining factors in the growth rate of the tax revenues of the state. As we have seen from the sectoral and sub-sectoral shares of the SDP, the base, on which the major tax, sales tax, which forms 67 percent of the total tax revenue of the state in 2001-02, is levied, is the stagnating secondary sector or the declining trade, hotels and restaurants. The scope of the need to tax the emerging sub-sectors within the service sector, which is currently outside the scope of the States' authority to tax, should be considered in this context. The long-term declines in the tax revenues and stagnation in the non-tax revenues pose a serious problem for resource

Figure 2. Growth Rate and Trend of Tax Revenue Growth in Kerala 1981-2001



Source: Computed from Economic Review 2002, Kerala

Figure 3. Growth Rate of Non Tax Revenue and Trend 1981-2001



Source: Computed from Economic Review, 2002, Kerala

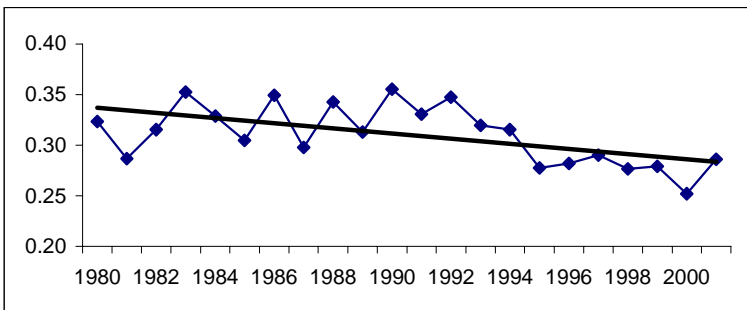
mobilisation. The composition of taxes needs to shift to the service sector. The mild decline in tax-SDP ratio (at the All-India level also tax-GDP ratio declined during the 1990s) from 10.29 percent in the 1980s to 9.84 percent in the 1990s, the decade that witnessed a fast

average growth rate of SDP at 6 percent also reflects the inability to tax the emerging service sector.

Criteria of Central Devolution- Adverse Impacts on Kerala

Kerala has been a victim of the normative criteria adopted for the devolution of grants under Article 275 by the Finance Commissions to cover non-plan revenue deficits. The Eleventh Finance Commission estimated post tax devolution non-plan revenue surplus for Kerala. The actual Balance of Current Revenue shown in the budgets reveals that the State has deficits in non-plan revenue account. The normative criteria have been out of touch with reality and need to be abandoned. The actual of the State expenditure and receipts could be made the basis for devolution of grants under Article 275 and certain items in non-plan expenditure can be made ineligible for grants. The criteria for

Figure 4. Central Shares as a Proportion of Revenue Receipts 1980-81 to 2001-02



Devolution of taxes has not been favourable to Kerala as can be seen from the trend of Central share in the revenue receipts of the State. The loan and grant component of 70:30 as per the Gadgil formula adopted

by the Planning Commission has been unfavourable to the States, especially Kerala where the capital component is less than 25 percent. The Central share as a proportion of revenue receipts has come down by 2 percentage points, from 32 percent in the 1980s to 30 percent in the 1990s implying that the formulae of devolution of fund by the Finance Commissions and Planning Commissions give a large explicit and implicit weightage to population and this has become unfavourable to States like Kerala which have undergone a demographic transition. Besides, criteria like Distance, with a weightage of 62.5 percent in the Eleventh Finance Commission, also are unfavourable to Kerala, since it has an implicit population weightage through the inclusion of per capita incomes.

In this context another suggestion that came forward²⁶ is that out of the Finance Commission devolution of the taxes, 50 percent may be based on criteria and 50 percent on budgets, though the budget performance indicators will have to be formulated and may not always be beneficial. But the preponderance of Population and Area as indicators (in Gadgil formula for transfer of Plan assistance, population gets 55 percent weight) is not in the interests of the State.

Public Debt of Kerala

The trend of the growth rate of public debt in Kerala has not been rising. When we take the debt-SDP ratio, the trend showed a fall in the 1990s, before rising in the late 1990s, when the SDP growth rate also slowed down during the late 1990s and there has been increasing burden due to pay revision of the Government employees.

When we empirically verify the growth rate of debt-SDP ratio, it has not been statistically significant during the 1990s²⁷.

Figure 5. Growth Rate and Trend of Public Debt in Kerala: 1971 to 2001

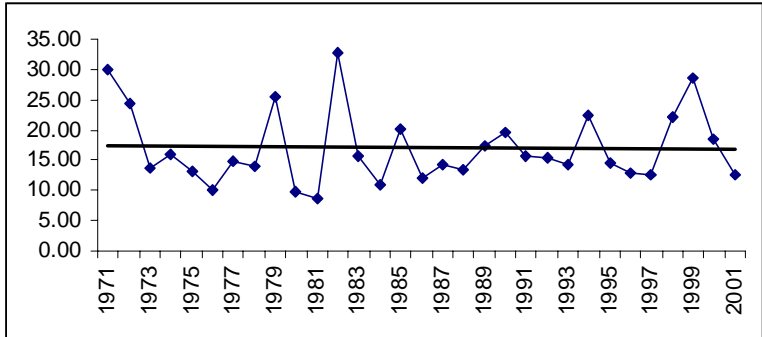


Table 6: Growth Rate of Debt-SDP Ratio in Kerala: 1980-2000

| Period | Coefficient | Standard Error | t-value | t-probability |
|--------|-------------|----------------|---------|---------------|
| 1980s | 0.0187 | 0.0087 | 2.154 | 0.044 |
| 1990s | -.00917 | 0.0078 | -1.175 | 0.255 |

$R^2 = 0.196$ $Dw = 1.62$ after AR (1) Correction.²⁸

But the fact that the growth rate of debt-SDP ratio has not been significant in the 1990s does not indicate that the fiscal strength has improved. (The trend growth rate of debt -SDP ratio is not statistically significant for the period 1980-2001²⁹). In fact the high cost component of debt, indicated by a high level of borrowing from the public account (Small Savings, Provident Funds, etc.) has gone up and this implies a large outgo of interest payments from the revenue receipts, which has reached 25.86 in 2000-01 from 7.61 in 1980-81. The fiscal problem is exacerbated, even with a non-significant rise in debt-SDP ratio as high cost component of debt has gone up, while own tax and non-tax revenue as well as Central share of revenue receipts have been declining. The State has been borrowing from sources like Toddy Tappers Welfare Fund and Co operative Societies at very high interest rates of 14 percent and

15 percent, according to Governmental sources. A detailed analysis of the borrowings from the Public Account is necessary for getting a clearer idea about the cost of borrowing.

The trend in public debt of Kerala, i.e. non-significant rise but increasingly costly debt, strengthens the State's case for higher devolution of Central funds. Though there can be argument that more own tax revenue needs to be mobilised, it is not a problem unique to Kerala. When analysed for the Centre and all States also, the same downward trend can be witnessed. But in Kerala's case more emphasis need be laid on non-tax revenues especially in social and community sectors, like education and health, but a strategic tackling of the demand groups is essential for its success. One of the main sources of non-tax revenue from forests has come down after the ban on clear felling.

If the main factors of fiscal crisis of Kerala are to be highlighted, they will be

- 1) *Increasing component of High Cost debt,*
- 2) *Resistance to levy of tax and non-tax revenue by demand and interest groups,*
- 3) *Declining Central shares especially nil grants under Article 275 form the Finance Commissions due to application of Normative criteria in estimating receipts and expenditure,*
- 4) *Unfavourable devolution criteria for taxes and grants by Finance and Planning Commissions, and*
- 5) *Decentralisation of funds without full transfer of functions and staff.*

The solution to these problems is partly economic and substantially political. The change in devolution criteria may not find

support from States that stand to benefit from the present criteria. But opinions of other States, which are also affected adversely, have to be mobilised. Tackling of interest groups requires political consensus and appropriate strategies and mobilisation of public opinion on the fiscal situation so that there can be more mobilisation of non-tax revenue. To overcome the traders' resistance to sales tax enforcement, fundamental tax administrative reforms and change in the mindset of enforcement is called for. These can be done by stopping assessments based on pure estimates, collection of evidence by strengthening information mechanisms and encouraging voluntary compliance by presumptive mechanisms and make selection for tax audit non-discretionary. The second-generation problems after considerable achievements in social sectors and human development and consequential fiscal strains have to be stressed before the Finance Commissions. Another problem calling for attention is high cost component of debt. Since the State has been doing relatively better in tax effort, there is a case for debt relief by making the non-significant increase of debt-SDP ratio and better tax effort new additional criteria. There has to be internal efforts as well as strong presentation of the Kerala's arguments before the Centre to overcome the fiscal problems faced by the State and this requires political consensus.

8. Summing Up

The Finance Commissions, especially the recent ones, have been given the task of recommending structural changes in public finances of the Centre and the States and the Terms of Reference attempt to make the Commission a vehicle for economic and fiscal reforms. But the traditional area of the Finance Commission in tax and grant devolution, especially the latter has become narrower, with the scope of looking at only non-Plan revenue deficits. We suggest an enlarged role for the

Finance Commissions in the traditional areas and leave the question of economic and fiscal reforms to respective governments in consultation with the Centre. The progress in achieving fiscal consolidation can of course be used by the Finance Commissions as a criterion for tax and grant devolution. But the concept of fiscal consolidation has to be much more broad based with attention to details of expenditure and revenue components than mere targeting of fiscal deficits. This is necessary to achieve the objective of economic growth with equity.

States like Kerala, which are now facing second-generation problems, are adversely affected by the traditional criteria for funds devolution like population and area. In a dynamic situation, there is need for change in criteria for devolution of funds to take care of the needs of States like Kerala. Unless the second-generation problems that have cropped up from the developmental experience of the past 50 years are recognised and factored into the federal financial relations the credibility of this important institution may be increasingly called into question.

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Notes

- 1 For States like Kerala the capital expenditure component of Plan expenditure has been as low as 25 percent according to the Tenth Five Year Plan Document 2002-07, Volume III on State Finances published by the Planning Commission, Government of India.
- 2 See the Report of the Eleventh Finance Commission on the experience in getting information on completed Plan projects, which became necessary for determining the maintenance expenditure part of the non-Plan account. This problem could have been avoided had the constitution of the Finance Commission been synchronised with the Five Year Plans (11th FC Report, Paragraphs 5.51 to 5.53, p. 51)
- 3 This has been retained in the TOR of the 12thFC with the addition of the words *debt reduction and equitable growth*. This is an indication of further enlargement of the scope of the Terms of Reference.
- 4 The fact that the acceptability of this measure has been challenged deserves mention. Illustrative examples in the literature on this subject are Gulati (1994), Rao and Amarnath (2000), Srinivasan (2000, p.48). Even the Union Finance Minister's Budget Speech, 2003 has to a certain extent recognised this, by stating that revenue deficit is the main worry and not the fiscal deficit. Rakshit (1991) and Balakrishnan (1997) have examined the relationship between fiscal deficit and macro economic variables and found practically no relationship. Balakrishnan (1997) points out that fiscal deficit as an instrument of macroeconomic tool has weaknesses.
- 5 The Centre credits the States' share of the small savings to the National Small Savings Fund (NSSF) and this does not form part of the Central borrowings since 1999-2000, whereas prior to 1999-2000, it formed part of Centre's borrowings. The ratio of division of small savings between the Centre and the States is 80:20. Fiscal deficit as a proportion of GDP prior to and after 1999-2000 is not directly comparable because of the change in definition of Central borrowings.
- 6 Also see articles by Ize, Mansoor in Blejer and Cheasty (ed.) 'How to Measure Fiscal Deficit' (1993) a publication of the International Monetary

- Fund, for a critical discussion on utilising disinvestment proceeds for reducing fiscal deficit.
- 7 Here we should take note of the fact that revenue deficit reduction and raising capital expenditure proportion have also been suggested by the 11th FC. We shall discuss quality of deficit reduction later.
 - 8 We are not entering into elaborate economic counter arguments to these propositions, which of course have been made by Rakshit (1991), Patnaik (2000), Chandrasekhar and Ghosh (2002), Fazzari (1994), Naastepad (1999) etc.
 - 9 This has been admitted by the Report on Currency and Finance 2000-01. The 2001-02 report however, reverses the argument stating that a deteriorating fiscal deficit due to rise in government expenditure has led to a lower growth. But the more convincing argument is that in a situation of deficient private demand along with a cut in government spending, there would have been adverse consequences on growth. It is noteworthy that this deteriorating fiscal deficit did not result in a higher inflation in the latter half of the 1990s, as there was excess capacity in the industry. This is a situation where an increase in revenue expenditure helped in sustaining growth, albeit in the short run. But having recognised by many that the growth constraints in the Indian economy are structural (Karnik 2001, *Report on Currency and Finance 2001-02*), an increase in capital spending in infrastructure is the basic requirement for achieving a higher growth.
 - 10 The advisability of monetisation of the part of the deficit has been discussed by Ramachandran et al (2002)
 - 11 To give examples, the phased reduction of deductions under Chapter VIA of the Income Tax Act 1961, like 80HHC for export profits etc.
 - 12 We recognise that this involves proper weightage to various aspects of QFD. This could constitute an exercise in itself. Our intention here is to emphasise the quality aspect. While doing so, we do not disregard the quantity aspect of deficit. In fact, both are interconnected. If the quality aspect suffers, i.e. by borrowing for current expenditure yielding no returns to service the debt in future, inadequate mobilisation of revenue etc., it will

result in splurging of future deficits. By emphasising on the quality aspect, we are indirectly, taking care of the quantity aspect also.

- 13 It is to be taken note of that by arguing for looking beyond the summary indicators like fiscal deficit and revenue deficit, we are not arguing for a lack of fiscal prudence. In fact, stressing on aggregate indicators is a soft option as this can be achieved by cutting capital expenditure and those components of revenue expenditure, which are not championed by interest groups. When we look at the quality of fiscal adjustment, we are in effect arguing for a harder option, the implementation of which requires political consensus in the long run interests of the economy and debt sustainability. Already the public debt of the Centre and the States has been treated as unsustainable (Buiter and Patel 1997, Reserve Bank of India, *Report on Currency and Finance*, 2001-02).
- 14 The present co-ordination set up is not working effectively. To illustrate, evaded income is many times camouflaged as agricultural income and declared in income-tax returns as very high (mostly non-existent) agricultural income. The Centre should pass on this information to the State tax machinery, which can levy tax on self-declared agricultural income. To cite an example of intertwining of tax base and how evasion hurts States twice, let us take the example of real estate transactions. When the value of the immovable property transacted is kept low in registered documents, a State loses stamp duty on the unreported value. The Centre loses capital gains tax (which is part of personal income tax) as the sale consideration reported is much below the actual. Since personal income tax is devolved to the States, they get a lesser amount. The State is hurt twice, first by loss of stamp duty and then by lower devolution, as Centre's kitty gets smaller due to capital gains tax evasion. A mechanism to check stamp duty evasion at State level by enforcing a reasonable guideline value for the purpose of stamp duty levy and making it the basis for capital gains tax computation by the Centre is necessary.
- 15 There is a service tax selectively taxing services at 8 percent and States are also taxing some services. What is suggested is integration of services and manufacturing into a single value Added Tax (VAT) at central and State level. For a discussion, see Rao (2001).

- 16 But one should take note of the fact that when the Fifth Pay Commission award was implemented the United Front Government at the Centre with a number of parties as coalition partners. Some of them were ruling the States. The United Front Government had the outside support of the Congress party. The opposition parties and unions were also supportive of the implementation of the package. Though States were not formally consulted, the political leadership of the parties ruling the States was seen as supporting the implementation of the Pay Commission award.
- 17 Productive expenditure need not always be capital expenditure. It can even be revenue expenditure. It is noteworthy that the noon-meal scheme, which was cited as an example of fiscal populism, is shown to have positive impacts on enrolment ratios and preventing dropout rates (see article by Jean Dreaze and Aparajitha Goyal in *Frontline* 15/08/2003). This will have a long run positive impact on more productive human capital formation, which will have a consequential positive impact on future economic growth. Dreaze and Sen earlier made a similar argument and this has been critically analysed by Shome (2002, pp.7-8).
- 18 There have been empirical studies disputing this. For citation and detailed discussion, see *Report on Currency and Finance*, Reserve Bank of India 2000-01.
- 19 Here, we have an example of handing over to private sector a function that is essentially in the domain of civic authorities, disposal of Municipal Solid Waste in Thiruvananthapuram City. This is the first Build Operate and Transfer Scheme (BOT), according to the authorities of the private company. This has neither resulted in efficient disposal of waste from the city nor environmentally safe methods of disposal of inorganic waste. More often than not, the plant stops working with the demand to the government for captive markets from the government agencies for the bio-fertilizer at prices higher than from others, according to the government sources. Now, there is a demand that the municipal authorities should take over the plant. Some clauses in the BOT agreement have landed Thiruvannathapuram Corporation in huge liability to the private sector partner. The larger example of Enron in Maharashtra is also there.

- 20 The recommendation of the Tenth Finance Commission for transfer of 29 percent of gross proceeds was not accepted by the Centre. Article 270 (2) after the Eightieth Amendment stipulates transfer of prescribed share of net proceeds. Net proceeds are net of Union Territories share and cost of collection of Central taxes.
- 21 Though not within the sub-national region as we discussed earlier, it needs to be recognised that it plays a very important role in attracting physical capital to a country (Mankiw 1995).
- 22 We are not in favour of taking a negative approach to the role of the mass organisations of various sections of the people. Positive role played by them in social empowerment and in the achievement of human development indicators like literacy level needs to be acknowledged. But competitive political compulsions have resulted in alluding emergence of consensus in issues like levy of user charges for social and community services even from those who have ability to pay.
- 23 Kerala will benefit from this as it is a state having very high tele-density compared to the national average i.e., 8.4 per 100 and rural tele-density is 7.06 in 2002 (*Economic Review 2002*, p.229).
- 24 At present services taxation is in the Residuary List and in the exclusive purview of the Centre, which selectively taxes services by increasing the list of services taxed in every Finance Act. The States like Kerala which have a higher share of services sector in State Domestic Product than the national average are neither able to tax the services sector nor get any added share from the devolution of service tax.
- 25 The *Economic Review of Kerala* describes 30 percent as a prudent debt - GDP ratio. There are methods like Domar's Stability equation, which stipulates that the real growth rate should not exceed real interest rate in the face of primary sector deficits. An alternative method of Buiter and Patel used by the *Report on Currency and Finance, 2001-02* of the Reserve Bank of India lays down that the discounted present value of the future debt should be stationary when tested for unit roots.
- 26 The suggestion came from Shri. K.V. Rabindran Nair, former Union Expenditure Secretary and former Kerala Chief Secretary in the Workshop

held in Centre for Development Studies, Thiruvananthapuram on 29 August 2003.

- 27 This is done using the Kinked exponential method, with the kink assumed at 1990.
- 28 The explanatory power of the model is low as the R^2 is low.
- 29 The trend growth rate of debt-SDP ratio (DSDR) was computed using the model $DSDR_t = a + bDSDR_{t-1} + cTrend + U_t$. The long-term trend growth can be computed as $c/(1-b)$. In this case the t-probability of the short-term trend itself is not significant. The results of the regression are not reported here.

APPENDIX

Table A1: Capacity Relatives and Effort relatives of States (1996-97)

| States | Percapita Income | Percapita Relative (CR) | Percapita tax | Tax Effort (ER) | Effort Relative |
|----------------------|------------------|-------------------------|---------------|-----------------|-----------------|
| Gujarat | 14875 | 156 | 1332 | 9.6 | 120 |
| Haryana | 16392 | 150 | 1155 | 7.1 | 89 |
| Maharashtra | 17666 | 162 | 1353 | 7.8 | 97 |
| Punjab | 18008 | 165 | 1223 | 6.7 | 84 |
| Tamil Nadu | 11708 | 107 | 1343 | 11.5 | 144 |
| West Bengal | 9579 | 88 | 571 | 6 | 75 |
| Andhra Pradesh | 10308 | 94 | 676 | 6.8 | 85 |
| Karnataka | 10504 | 96 | 1169 | 11.4 | 142 |
| Kerala | 10309 | 94 | 1269 | 13.9 | 174 |
| Bihar | 4231 | 39 | 242 | 6.3 | 79 |
| Madhya Pradesh | 7571 | 69 | 553 | 7.4 | 92 |
| Orissa | 5893 | 54 | 390 | 6.1 | 76 |
| Rajasthan | 8974 | 82 | 628 | 7.4 | 92 |
| Uttar Pradesh | 6713 | 61 | 402 | 6 | 75 |
| Average Index | 10909=100 | | | 8=100 | |

Table A2: Capacity Relative and Effort relative of - State-wise Performane

| States Group | 1970-71 | 1980-81 | 1990-91 | 1996-97 |
|--------------|--|--|---|--|
| ER>CR | Maharashtra, Tamil Nadu, Andhra Pradesh, Karnataka, Kerala, Bihar, Rajasthan | Tamil Nadu, Andhra Pradesh, Karnataka, Madhya Pradesh | Tamil Nadu, Andhra Pradesh, Karnataka, Madhya Pradesh, Orissa, Rajasthan, Uttar Pradesh | Tamil Nadu, Karnataka, Kerala, Bihar, Madhya Pradesh, Orissa, Rajasthan, Uttar Pradesh |
| ER<CR | Gujarat, Haryana, Punjab, West Bengal, Orissa, Uttar Pradesh | Gujarat, Haryana, Maharashtra, Punjab, West Bengal, Orissa, Rajasthan, Uttar Pradesh | Gujarat, Haryana, Maharashtra, Punjab, West Bengal | Gujarat, Haryana, Maharashtra, Punjab, West Bengal |
| ER=CR | Madhya Pradesh | | | |

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