GOVERNMENT OF KERALA

MEDIUM TERM FISCAL POLICY & STRATEGY STATEMENT WITH MEDIUM TERM FISCAL PLAN FOR KERALA 2015-16 to 2017-18

FINANCE DEPARTMENT

2015

FOREWORD

The Kerala Fiscal Responsibility Act 2003 mandates that the Medium Term Fiscal Policy and Strategy Statement should be presented before the state legislature every year along with the annual budget documents. In contrast with the lacklustre economic growth during the past two years, the Indian economy is showing some indications of a potential revival. Despite that, several inherent problems, some of which are legacies left by the past are slowing down the economic development in Kerala. At this juncture, devising efficient strategies to develop Kerala into a state with a strong financial foundation is imperative.

The increasing divergence between income and expenditure has evidently led Kerala to its current state of financial difficulty. However, it is neither possible nor prudent to be excessively parsimonious as expenditure on the huge development works in progress cannot be curtailed. To ease the fiscal stress that Kerala is currently experiencing, several tax reforms and stringent policies had to be adopted by the state administration during the fiscal 2014-15. As a result of this, there has been a marginal increase in the tax collection in the last quarter of the 2014-15 on an year-on-year basis.

The upcoming 2015-16 financial year will be the first year of the 14^{th} Finance Commission. Radical changes in the centre-state financial relationship characterise the recommendations of the 14^{th} Finance Commission. After a long span, Kerala has become eligible for a small but welcome increase in the share of central taxes. Amendment of the FRBM Act is necessary to conform to the roadmap set out by the 14^{th} Finance commission. I am confident that we will be able to progress along the fiscal consolidation path prescribed by the 14^{th} Finance Commission.

I solicit the wholehearted support and sincere co-operation of all for our onward fiscal journey towards achieving the targets stipulated.

I have pleasure in presenting before you, the Medium Term Fiscal Policy and Strategy Statement 2015-16.

K M Mani
Minister for Finance

MEDIUM TERM FISCAL POLICY AND STRATEGY STATEMENT WITH MEDIUM TERM FISCAL PLAN FOR KERALA

INTRODUCTION

1. The Medium Term Fiscal Policy Statement for the current year in accordance with Kerala Fiscal Responsibility Act 2003 is presented in the backdrop of 14th Finance Commission recommendations. While the recommendations of the Commission are in line with the stand of Government that central transfers should be untied, the commensurate decrease in plan grants pose serious threat to the stability of state finances. The enhancement of vertical devolution from existing 32% to 42 % and horizontal devolution of 2.341% to 2.500% is the biggest devolution made by any Finance Commission per *se,* but it should be seen from the backdrop of the fact that gross transfers to States still remain at the 61-62% limit. The State does benefit moderately from the devolution package. In particular, the Revenue Deficit Grant will help the State to return to its fiscal consolidation path at the earliest.

RECENT MACROECONOMIC DEVELOPMENTS IN GLOBAL ECONOMY

2. The global economy is emerging from the worst financial and economic crisis it had faced. The growth in various economies continue to be uneven and significantly lower than what was anticipated even in advanced market economies. The five facets of Global Economy at the dawn of 2015 are falling oil prices, appreciation of US dollar ,weakening of economies of Japan and China, crisis in European Union due to Greek Debt and fiscal contagion in Russia. The recent World Economic Outlook Update of IMF released in January 2015, projected global growth in 2015 and 2016 at 3.5 percent and 3.7 percent respectively. But the World Bank projected an even lower growth of 3 and 3.3 percent for the same period. After the financial crisis the growth prospects in advanced countries are better than they have been in recent years, albeit the stagnant euro area growth. The recovery in United States seems to be grounded with strong output and employment figures. Oil prices have declined by more than half, from $115 a barrel in June 2014 to $46 a barrel in January 2015. The major reasons attributed to the falling oil prices vary significantly, viz. pure supply-demand balances, enhanced shale gas production in US, weakening of demand due to slow growth in China and reluctance of OPEC countries to lower the production. The additional fiscal space due to the fall in oil price is a welcome relief to oil importing countries which confront serious Current Account Deficits (CAD) and Balance of Payment problems. The robust recovery of US economy is partly attributed to the appreciation of US dollar. As of January 2015, it appreciated around 6 percent relative to October 2014. The decrease in investment growth in China after a recent credit and investment growth give mixed signals about the growth prospects. The slow pace of growth in China is considered as principal reason for the fall in demand of oil. Recently IMF had reduced the projections of growth rate of China to 6.8 and 6.3 for 2015 and 2016 respectively. China is the largest trading partner of our country. Growth in Chinese consumption in recent years (it grew 10.9% in 2014) is a boost to Indian economy. With this end in view India has been pressurising China to open up more IT, pharmaceutical and agricultural sectors besides investing in India. The sluggish performance of Japanese economy in the third quarter of 2014-15 gives an indication of further deceleration of

world economy in the coming months. The sharp geopolitical and economic tensions between Greece and other members of European Union and tensions between west and Russia over Ukraine crisis are negatively affecting the recovery of global economy.

3. The possibility that oil prices may rebound, volatility in global financial market, sluggish growth in China and Euro areas and appreciation of US dollar against Rupee will pose substantial risks to macroeconomic stability in India

National Scenario

4. The turnaround in Macro-economic prospects of the economy in late 2013 tilted the fortunes in India's favor. Inflation has declined, economic growth has accelerated to 7.4 percent, as per advance estimates of GDP (at market prices, Base=2011-12), CAD has rebounded from a peak of 6.7 percent of GDP, oil prices have plummeted and the country has been able to maintain adequate stock of food grains stock in FCI godowns. After a period of unprecedented growth of around 9 percent (except in 2008-09 when growth is just 6.7 percent), the Indian Economy slowed down to a growth rate of below 5 percent (as per GDP 2004-05 base figures). Among the Emerging Market Economies (EME's), India was grouped with 'Fragile Five' (Brazil, Indonesia, India, Turkey and South Africa). In terms of the Macroeconomic Vulnerability Index (MVI), India leads this group with an aggregate index value of 21.7 which was above the safe and sustainable level of 12. The moderate growth and inflated CAD cannot be attributed to the global situation alone but is also predominantly due to domestic factors like structural impediments, high inflation, vulnerable balance of payment weakening of rupee and weakened external demand. Average retail inflation reached double digits during the period. During the last year India could successfully reduce its vulnerabilities to adverse shocks through tighter macroeconomic policies to reduce inflation and narrow external current account deficits. A number of policy initiatives like liberalization of FDI norms, increase in the FII limits in respect of domestic debt securities gradual deregulation of diesel prices etc have been taken to contain CAD.

Table 1: Macroeconomic Vulnerability Index

	2012-13	2014-15 (BE)	Safe level
CAD	4.7	1.3	2
FD(combined)	6.8	6.4	6
Inflation	10.2	7.2	4
MVI	21.7	14.9	12

Source: Economic Review 2015, Midyear Economic Analysis Ministry of Finance, World Economic Outlook 2014 (IMF)

5. The share of agriculture and industry has risen while there has been a fall in the share of services sector. This is reflected in the new measurement methodology for national income adopted by CSO. During the last week of January 2015 Central Statistical Office (CSO) introduced a new series of National Income with two important changes. One is the change of base year from 2004-05 to 2011-12, which is a periodical exercise. The second is a landmark change in income measurement in India. A new method viz. Gross Value Added (GVA) is introduced which incorporated information from new data sets. This replaces the practice of measuring GDP at factor Cost with GVA at Base Prices. The GDP at market prices will be referred as GDP in future. This resulted in four consequential changes: (1) GDP growth has been revised to 6.9 % in 2013-14 as against 5.0% in the old series for the same period (2) coverage of certain items like trade carried out by manufacturing companies etc. has increased (3) Index of Industrial Production (IIP) which is now based on 2004-05 is no longer a good indicator of industrial growth (it will be revised only in 2015-16 only) and (4) with the introduction of GVA, Indian accounting standards

have become compatible with System of National Accounts (SNA), 1993 proposed by United Nations. The different measurement of National Income and sector wise decomposition of the economy may be seen in table 2 and table 3 below.

Table 2: Estimates of National Income at Constant Prices (2011- 12 Prices) [Rs. in Crore]

Sl.No	Item	2011-12	2012-13	2013-14	2014-15*	Percentage change over previous year		
						2012-13	2013-14	2014-15*
1	GVA at basic prices	8195546	8599224	9169787	9857672	4.9	6.6	7.5
2	Taxes on Products	886969	978603	1037006	1086552	10.3	6.0	4.8
3	Less Subsidies on Products	250503	297024	285687	287299	18.6	-3.8	0.6
4	GDP (1+2-3)	8832012	9280803	9921106	10656925	5.1	6.9	7.4

Source: CSO

Table 3: Growth of GVA at Basic Prices by Economic Activity (at 2011-12 Prices) (in per cent)

Sector	Growth			Share in GVA		
	2012-13	2013-14	2014-15 *	2012-13	2013-14	2014-15*
Agriculture, forestry & fishing	1.2	3.7	1.1	17.7	17.2	16.2
Industry	2.4	4.5	5.9	32.3	31.7	31.2
Mining & quarrying	-0.2	5.4	2.3	3	3	2.9
Manufacturing	6.2	5.3	6.8	18.3	18.1	18
Electricity, gas ,water supply& other utility services	4.0	4.8	9.6	2.4	2.3	2.4
Construction	-4.3	2.5	4.5	8.6	8.3	8
Services	8.0	9.1	10.6	50	51.1	52.6
Trade, hotels, transport, communication and services related to broadcasting	9.6	11.1	8.4	18	18.8	18.9
Financial, real estate & professional services	8.8	7.9	13.7	19.5	19.7	20.9
Public administration, defense and Other Services	4.7	7.9	9.0	12.5	12.6	12.8
GVA at basic prices	4.9	6.6	7.5	100.0	100.0	100.0
GDP at market prices	5.1	6.9	7.4	--	---	---

Source: CSO. *: Advance Estimates.

6. Commensurate with the changes in GDP, CSO has also revised Consumer price Index (CPI) from the base year of 2010 to 2012.After the base year revision, CPI inflation stood at 5.11% in January 2015 as against 4.28% in December 2014. The figures are well below the RBI inflation target of 8% for January 2015. The new GDP series reveals a stronger-than-expected recovery while the new CPI series indicates lower inflationary pressures. The changed macroeconomic conditions and reduced inflationary pressure give necessary impetus for easing the monetary policy in March 2015 by RBI. The statutory liquidity ratio (SLR) of scheduled commercial banks has been reduced by 50 basis points. Repo rate under the Liquidity Adjustment Facility (LAF) has been reduced by 25 basis points from 7.75% to 7.25 % but the reverse repo stands adjusted to 6.5% and the Marginal Standing Facility (MSF) rate and Bank rate reduced to 8.5%. Cash Reserve Ratio (CRR) has been kept constant at 4.00%. If the

spatial and temporal distribution of monsoon is normal and crude oil prices do not record a sharp rebound, CPI inflation in 2015 is expected to remain in line with the Central Bank's medium term threshold, Therefore policy rate may remain within a narrow band in the next fiscal year.

14TH FINANCE COMMISSION RECOMMENDATIONS & UNION BUDGET 2015-16: IMPLICATIONS FOR THE STATE GOVERNMENT

7. The Medium term fiscal policy framework of states in general and Kerala in particular is chareterised by two important developments, the 14th FC recommendations and presentation of Union Budget for 2015-16. The 14th FC, while keeping the pure spirit of fiscal federalism enshrined in the Constitution, hiked the vertical devolution from 32% of the divisible pool to 42%. The local body grants in absolute terms is also hiked to ₹ 2,87,436 crore for 2015-20 which includes a basic grant of ₹ 2,49,978 crore and a performance grant of ₹ 37,458 crore. Disaster Relief grant of ₹ 55,097 crore and post Devolution Revenue Deficit Grant of ₹ 1,94,821 crore is also recommended for the same period. Horizontal devolution share is also revised and accordingly, Kerala's horizontal share is also hiked from 2.341% to 2.500%

8. While presenting the Action Taken Report, Union Government accepted the recommendations on the vertical and horizontal devolutions and local body grants in toto with a slight modification on the Disaster Relief Fund. But in the case of Revenue Deficit grant, the Union government accepted the recommendation 'in principle'. In the present scenario it is expected that as against a devolution of around ₹3.48 lakh crore in 2014-15, there will be a growth of around ₹ 1.78 lakh crore in the total devolutions in 2015-16

9. While, as the 14th FC itself acknowledges, its recommendations may not signify a big increase in total fiscal transfers to the States, the entire resources from center are untied as against the recommendations of previous two Finance Commissions. Thus the resources transferred are not encumbered by the discriminatory and one-size-fits-all central schemes and rules. It will also help enhance the fiscal independence of states and confer greater autonomy to the States to spend according to their priorities and needs.

10. The examination of rationale of recommendations of 14th FC unravel some infirmities. The criteria used for determining the vertical share vis-à-vis the 13th Finance Commission is shown in Table 5. The new criteria of forest cover and elimination of fiscal discipline criteria are advantageous to Kerala. At the same time introduction of demographic change using 2011 census data and concomitant reduction in the share based on 1971 population are detrimental to the state. This is against the spirit of Terms of Reference of the Commission as it states that in all cases where population is a factor for determination of devolution of taxes and duties and grants-in-aid, 1971 population should be taken. This should be so, indeed, as it has been used as a measure for determining parliamentary seats of a state, Gadgil-Mukherjee formula for plan assistance and FC devolutions. In a recent study (published in EPW issue dated 1.1.2014) difference in the share of all states using the 1971, 2001 and 2011 population was analyzed. As per that study, the unscaled share of Kerala would be 1.983. If 2001 population is used , the share would have been 1.901 and if 2011 population is used the share would have been 1.712. But 13th FC used 1971 population only and the inter se share of Kerala was fixed at 2.341. From the exercise, the importance of using 1971 population is well established. Regrettably

Table 4: Composition of Criteria

Criteria	13th FC	14th FC
Population (1971 Census)	25	17.5
Income Distance	47.5	50
Area	10	15
Forest Cover	NC	7.5
Demographic Change	NC	10
Fiscal Discipline	17.5	NC
Total	100	100

so, this decision of 14th FC will have far reaching consequences which will adversely affect the prospects of our state in the recommendations of future Finance Commissions.

11. Another important point is the estimate relied by the Finance Commission on arriving at pre devolution revenue deficit. As per the estimates of FC, the own tax revenue of the state would grow by 14% and revenue expenditure by 11% throughout devolution period. Comparing with the projections of 14th FC, the estimates of the State are more realistic. The state projected a growth of 15% for Revenue receipts. But estimate of revenue expenditure is above 15% taking into account the impact of committed expenditure like quinquennial pay revisions, a fact which has been completely missed out in the assessments of Finance Commission. Mainly on this account, Finance Commission has given the Pre devolution Revenue Deficit as ₹ 1,,03,121 crore as against State's projection of ₹ 2,63,353 crore. Thus Revenue Deficit grant recommended is much less. The third significant concern is the criteria used for devolving local body grants. The 13th FC used Population, Area, Distance from highest per capita sectoral income, Index of devolution, SC/STs proportion in the population and FC local body grants utilisation index. But the criteria used by 14th FC is population (weightage 90%) and area (10%).In addition 2011 population is also used. This excess weightage given to population and usage of 2011 population adversely affects the state in local body grants. Nevertheless the quantum jump in transfers, as seen in table 6 holds out some promise to the State. Inexplicably however, in the Union Budget proposals the divisible pool is estimated much below than that of 14th FC recommendations and the share of taxes is only ₹13121.77 crore as against the expected ₹14511 crore for the year 2015-16.

Table 5 : Fiscal Impact of 14th FC Recommendations to Kerala ₹ in crore

	2015-16	2016-17	2017-18	2018-19	2019-20	2015-20
Share of Taxes (recommended) $	14511.00	16745.00	19348.00	22383.00	25925.00	98912.00
Share of Taxes (Provided in BE)*	13121.77					
Basic Grant-Rural	433.76	600.62	693.96	802.78	1084.73	3615.85
Basic Grant-Urban	351.66	486.94	562.61	650.84	879.42	2931.47
Performance Grant-Rural		78.78	89.16	101.25	132.57	401.76
Performance Grant-Urban		143.71	162.63	184.69	241.83	732.86
SDRF (Recommended)	185.00	194.00	204.00	214.00	225.00	1022.00
SDRF(sanctioned)#	138.75	145.50	153.00	160.50	168.75	766.50
RD Grant	4640.00	3350.00	1529.00	0.00	0.00	9519.00
Total (Recommended)	20121.42	21599.05	22589.36	24336.56	28488.55	117134.94
Total (Sanctioned)	18685.94	21550.55	22538.36	24283.06	28432.30	115490.21
Difference	1435.48	48.50	51.00	53.50	56.25	1644.73

Note: $ As per divisible pool estimated by 14th FC * Provided in Union Budget for 2015-16 # As per ATR, the central and state share as in the earlier pattern of 75:25 will be continued till the implementation of GST regime

Table 6: Revenue Deficit Grant *(₹ in crore)*

		2015-16	2016-17	2017-18	2018-19	2019-20	2015-20
Finance Commission Estimates	Own Revenue	52851	60114	68498	78199	89467	349129
	Revenue Expenditure	72002	80209	89375	99613	111051	452250
	Pre Devolution Revenue Deficit	19151	20095	20877	21414	21584	103121
State of Kerala Estimates	Own Revenue	51854	59648	68679	79152	91302	350635
	Revenue Expenditure	93419	102398	121247	138493	158431	613988
	Pre Devolution Revenue Deficit	41564	42750	52568	59341	67129	263353
	Tax Devolution of as per FC	14511	16745	19348	22383	25925	98912
	Eligible Revenue Deficit Grant	27053	26005	33220	36958	41204	164441
	RD Grant recommended	4640	3350	1529	0	0	9519

12. The current fiscal constraints faced by the Union government and its budget proposals for 2015-16 has detracted from the moderate optimism given by 14th Finance Commission. Albeit favorable conditions like fall in oil prices, moderate inflation, strengthening of industrial growth since the last quarter of the current fiscal, the fiscal consolidation trajectory opted by the union government is adversarial to the state. The current fiscal situation of the union government can be seen in table 10 below. From the table it is clear that the revenue receipts as a percent of budget estimate is lower than that of corresponding period of previous year. But at the same time expenditures are on the higher side. All deficit indicators has crossed budget estimates in December of the current fiscal which poses serious questions about achieving fiscal consolidation targets. The fiscal consolidation in general and tax raising capacity of the union government in particular is equally pivotal to the fiscal space of states. The Union Budget for the year 2014-15 envisaged a fiscal deficit of ₹ 5,31,177 crore, around 4.1 percent of GDP (2004-05 base). But during April- December period of the current fiscal, Fiscal Deficit crosses the estimated Fiscal Deficit. Surprisingly while presenting Union Budget for 2015-16, the revised estimate of FD for 2014-15 is stated as ₹ 5,12,628 crore, i.e. ₹ 18,549 crore less than that of Budget Estimate albeit retaining the FD-to GDP target at the same level by assuming that nominal GDP grow at a rate of 11.5% over advanced estimates for 2014-15 . The quality of FD as reflected in the RD-FD ratio does not appear to be good. The RD-FD ratio of the budget estimates and revised estimates hover around 70%. The revenue collection front does not give rise to any great optimism. As would appear from the budget figures, the targeted ratio can be achieved only by compressing the capital expenditure and reducing social sector expenditure and additional revenue mobilisation by disinvestment. Another important aspect is the sluggish tax collection of Union government. It is estimated that there is a decrease of ₹ 105732 crore in six major items of central tax revenue that constitute divisible pool for the current fiscal. This would imply that the State's share will decrease by ₹ 34207 crore during the current fiscal itself. The weakness in revenue collection capacity of Union Government has serious ramifications on the state governments. The sharply reduced tax revenues of the Centre affects fiscal headroom for states to consolidate their fiscal position. This will seriously affect budgetary planning of state governments.

13. In the medium term, the fiscal policy of the

Union government for the coming fiscal is regressive deviating from the recommendations of the Finance Commission. This is evident from the transfers under plan. From 2014-15 BE to 2015-16 BE, the share of central taxes has been increased by ₹1,41,742 crore and grants by ₹ 38,611 crore. But the central assistance to State &UT plan has been reduced by ₹ 1,33,934 crore. This is done by rearranging the current plan assistance in to three categories. In the restructured framework, full assistance will be given to 34 plan schemes which are legally mandated (eg MGNREGA), backed by cess collection (eg SSA) , funded from National Clean Energy Fund and those targeted for socially backward groups. 20 umbrella schemes have been identified for change in the sharing pattern with likely non coverage for its revenue expenditure component. These include schemes which critically impact the poor and the marginalised like RKVY, Food Security Mission Swatch Bharat Abhiyan, NRLM, National Aids Control Programme etc. 8 schemes will be completely delinked from the support of union government. Considering the fiscal constraints of the union government and its stagnant tax-GDP ratio, the resources for first group of scheme may not increase in the near future. Continuing the second group of revised plan schemes will put great pressure since these schemes require considerable recurring expenses as most of the schemes have been running. Evidently the schemes with changed patterns and schemes which is delinked from the support of the center can be continued only if the states can provide additional budgetary support from its own revenues or transfer a significant portion of their legally mandated transfers to support and continue the schemes which were envisaged by the center. Thus the greater share of tax devolution is clearly more of a chimera which carefully conceals massive reductions in central assistances to State plans. For this rearrangement, Plan assistance has been reduced by₹ 1.33 lakh crore, which will squeeze the budgets of state governments in a significant manner. What is perhaps not so obvious is that the total increase in transfers to the states is only ₹ 63,997 crore in 2015-16 BE over 2014-15 BE, as a percent of GDP the transfers shows a decline. It implies that even though the states would enjoy greater fiscal autonomy and flexibility in terms of expenditure priorities, the additional fiscal capacity of state government is very modest or virtually nonexistent.

Table 7:Composition of Transfer of resources to States (₹ in crore)

Sl No	Items	2014-15 BE	2015-16 BE	Differ-ence
1	Share of Taxes	382216	523958	141742
2	Non plan grants & Loans	70019	108630	38611
3	Central Assistance to State &UT plan	329712	195778	-133934
4	Central Assistance to CSS & Central Schemes	5851	23869	18018
5	Less Recovery of loans & Advances	8832	9272	440
6	Total Transfer to States & UT	778966	842963	63997
7	GDP	12653762	14108945	1455183
8	Total Transfer as a percent of GDP	6.2	6.0	-0.2

Table 8 : Union Government Accounts at a Glance

(Rs in Billion)

Item	Financial Year	April–December				
	2014-15 (BE)	2013-14 (Actuals)	2014-15 (Actuals)	Percentage to Budget Estimates		Col.3 as a percent of Col.1
				2013-14	2014-15	
	1	2	3	4	5	6
1 Revenue Receipts	11,897.6	6,339.3	6,937.7	60.0	58.3	58.3
1.1 Tax Revenue (Net to Center)	9,772.6	5,176.6	5,457.1	58.6	55.8	55.8
1.2 Non-Tax Revenue	2,125.1	1,162.7	1,480.6	67.5	69.7	69.7
2 Capital Receipts	6,051.3	5,298.6	5,426.2	87.0	89.7	89.7
2.1 Recovery of Loans	105.3	80.4	82.8	75.4	78.7	78.6
2.2 Other Receipts	634.3	54.3	19.5	9.7	3.1	3.1
2.3 Borrowings and Other Liabilities	5,311.8	5,163.9	5,323.8	95.2	100.2	100.2
3 Total Receipts	17,948.9	11,637.9	12,363.9	69.9	68.9	68.9
4 Non-Plan Expenditure	12,198.9	8,125.3	8,837.6	73.2	72.4	72.4
4.1 On Revenue Account	11,146.1	7,311.6	8,132.7	73.6	73.0	73.0
4.1.1 Interest Payments	4,270.1	2,484.6	2,752.2	67.0	64.5	64.5
4.2 On Capital Account	1,052.8	813.7	704.9	69.5	67.0	67.0
5 Plan Expenditure	5,750.0	3,512.6	3,526.3	63.3	61.3	61.3
5.1 On Revenue Account	4,535.0	2,740.2	2,822.8	61.8	62.2	62.2
5.2 On Capital Account	1,215.0	772.5	703.5	68.9	57.9	57.9
6 Total Expenditure	17,948.9	11,637.9	12,363.9	69.9	68.9	68.9
7 Revenue Expenditure	15,681.1	10,051.8	10,955.5	70.0	69.9	69.9
7.1 of which grants for creation of capital Assets	1,681.0	960.6	978.6	55.0	58.2	58.2
8 Capital Expenditure	2,267.8	1,586.2	1,408.4	69.2	62.1	62.1
9 Revenue Deficit	3,783.5	3,712.4	4,017.8	97.7	106.2	106.2
10 Fiscal Deficit	5,311.8	5,163.9	5,323.8	95.2	100.2	100.2
11 Gross Primary Deficit	1,041.7	2,679.3	2,571.6	155.9	246.9	246.9
12.Effective revenue Deficit	2,102.5	2,751.8	3,039.2	157.6	144.6	144.6

Source: Controller General of Accounts, Ministry of Finance, Government of India.

Table 9:Items of Divisible Pool of union Taxes

	2014-15 BE	2014-15 RE	Difference
	1	2	(2-1)
Corporation Tax	451005	426079	-24926
Income Tax	284266	278599	-5667
Wealth Tax	950	950	0
Customs	201819	188713	-13106
Union Excise	207110	185480	-21630
Service Tax	215973	168132	-65329
Total	1361123	1247953	-105732
Share to States	382216	348009	-34207#

Source: Union Budget 2015-16 # excludes adjustment

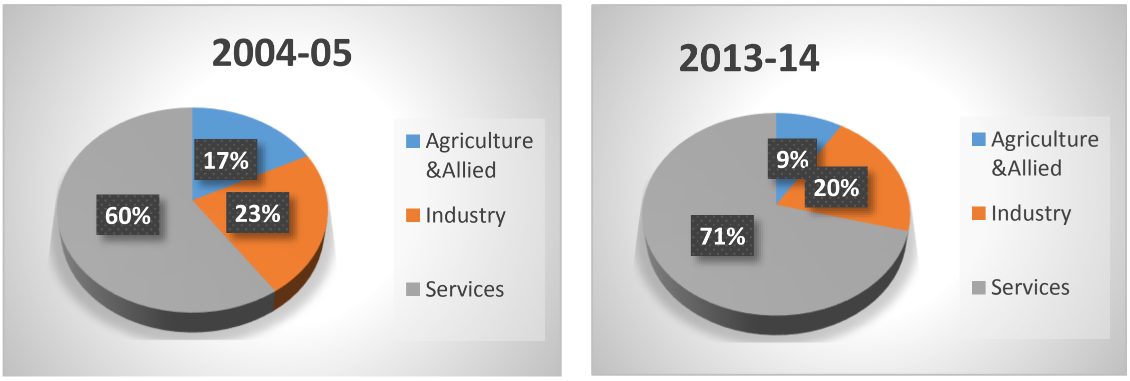
OVERVIEW OF THE STATE'S ECONOMY

14. Kerala Economy have been grappling with three important problems, one is the reduction in the share of agriculture and allied sectors and sluggish performance of industrial sector in State Income. The third is the severe resource crunch faced by the state for undertaking development expenditure.

15. In 2004-05, the share of agriculture and industry in state income was 17% and 23% respectively. But in 2013-14, the share of these two crucial sectors has declined to 9% and 20% respectively. In line with the national trend,

industry shows its worst performance in the last decade by showing a negative growth in 2013-14 (Quick Estimates). In this context it is pertinent to note that in 1970-71, the agriculture was the growth engine of the economy with around 50% of the State Income. But from eighties onwards the share of agriculture began to diminish, largely due to rapid demographic change and associated socio-economic changes. In 1980-81, the share of agriculture was 31.6% and it further reduced to 29% in 1990-91. But from the last decade the deceleration of agriculture sector has been particularly steep. In 2000-01, the share was reduced to18.25%. With the decline in agriculture and allied sector the economy witnessed an increase in the activities of services sector. The composition and growth rate of different components of Kerala economy may be seen at chart 1 & 2 below. Throughout the 2004-05 to 2013-14 period the growth rate of agriculture has been oscillating within a narrow band. The service sector has grown more or less steadily except in 2008-09, in tandem with the global recession and in 2012-13 and 2013-14 in line with the national economy. But the industrial growth shows a steep fall in 2013-14 from 2012-13, owing to sluggish industrial activity witnessed in the country in general.

Chart 1: Sectoral Composition of Kerala Economy



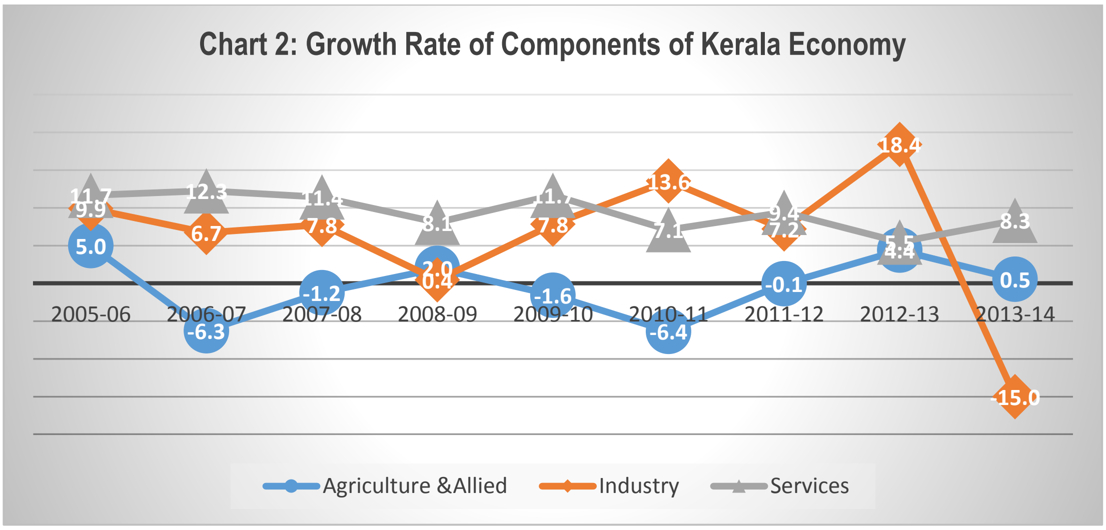


Chart 2: Growth Rate of Components of Kerala Economy

STATE FINANCES: SUSTAINABILITY, KEY POLICIES AND MEDIUM TERM FISCAL PLAN

16. The financial year 2014-15 has been marked by pronounced financial difficulties in the state as at the national level. The estimated revenues in the previous budget could not be realized due to the slowdown in the economy particularly in

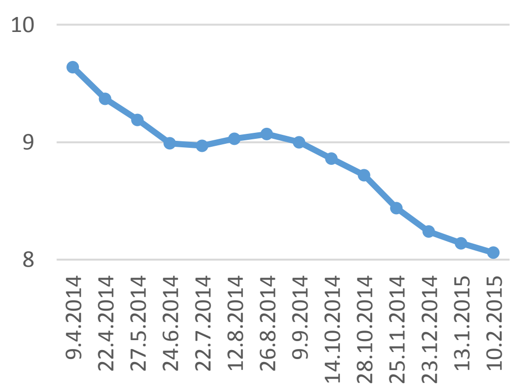
industrial and services sector and an acute reduction in the share of taxes from the center. But in the midst of all these difficulties, the state was able to provide enough resource in the social and educational sectors. The present state of state finances may be seen in the table below. In 2013-14, the growth in revenue receipts declined to 11% after witnessing high growth of 16% in 2012-13 and 23% in 2011-12. In Budget 2013-14, total expenditure was targeted at ₹ 70,076 crore. This expenditure was to be met through receipts (other than borrowings) of ₹ 58,204 crore and borrowings of ₹ 12,314 crore. However, since there was a drastic fall in the revenue receipts and central government transfers against RE 2013-14 state had to rely more on public debt. This increased the gross borrowing and other liabilities against the budgeted figures. Due to swelling in expenditure of revenue nature including interest on loan disproportionate to revenue, state could not achieve the target which proved to be unrealistic. Target fixed by the 13th FC and as targeted in the Kerala Fiscal Responsibility Amendment Act 2011 in respect of RD, FD and Outstanding debt as a percent of GSDP were 0.5%, 3.0 % and 30.7 % respectively. But in reality achievement in respect of first two indicators were way below the target at 2.85% and 4.28 % respectively. In the case of third indicator, however the state could contain the debt to GSDP ratio well below the target of 30.03%.

Table 10: State Government Accounts-Medium Term (₹ in Crore)

Sl.No	Items	Financial Year	April-December		% of Actuals to Budget Estimate		Col.2 as a percent of Col.1
		2014-15	2014-15	2013-14	2014-15	2013-14	
		1	2	3	4	5	6
1	Revenue Receipts	64842	40227	34053	62	71	62
2	Tax Revenue	51833	31159	28225	60	72	60
	(I)State's Own Tax Revenue of which	42467	25372	22990	60	72	60
	Stamps & Registration	3735	1909	1873	51	50	51
	Taxes on sale including VAT	31933	20127	17929	63	76	63
	State Excise Duty	3208	1250	1374	39	54	39
	Taxes on Motor Vehicles	2800	1744	1547	62	91	62
	(II)Share of Central Taxes	9365	5786	5235	62	74	62
3	State's Non Tax Revenue(I+II)	13009	9068	5827	70	65	70
	(I)State's Own Non-Tax Revenue	6337	4103	3103	65	89	65
	(II) Grants from the Centre	6672	4965	2724	74	50	74
4	Non Debt Capital Receipts(I+II)	173	98	76	57	71	57
	(I) Recovery of Loans	148	84	66	57	75	57
	(ii) Other Receipts	25	14	10	57	52	57
5	Borrowings and other liabilities including public account (net)	14543	5825	5825	40	53	40
6	Total Receipts (1+4+5)	79559	46150	39954	58	67	58
7	Non Plan Expenditure (I+II)	62617	43895	35344	70	75	70
	(I) ON Revenue Account of which	60947	43331	33828	71	78	71
	(II) On Capital Account of which	1670	563	1516	34	38	34
8	Plan Expenditure	16797	8371	4647	50	39	50
	(I) On Revenue Account of which	11028	5744	3017	52	36	52
	(II)On Capital Account	5770	2627	1629	46	48	46
9	Total Expenditure	79414	52266	39991	66	68	66
10	Fiscal Deficit	14398	11941	5862	83	55	83
11	Revenue Deficit	7132	8848	2793	124	81	124
12	Primary Deficit	4800	6253	4180	130	120	130

17. During April-December period of the current fiscal, the revenue receipts and total expenditure have already crossed 62% and 66% of the budget estimates respectively. But there are two worrisome trends. First, the slackness in revenue collection especially in sales tax, state excise and motor vehicles tax and the diminishing share of central taxes. The second one is about the deficit indicators. Revenue deficit and primary deficit has already crossed the budgeted amounts in December 2014. Fiscal deficit has crossed over 80% of the budget estimates in the same period. As a part of fiscal consolidation efforts, to control non developmental expenditure and for revenue augmentation, the state imitated a number of measures in September 2014. A slight improvement is visible in the revenue mobilization particularly in the last quarter of the current fiscal. Tight control is being made on revenue expenditure to prevent mounting deficits. A slight moderation in AICPI-IW inflation, which determines the quantum of dearness allowance to be disbursed to government employees as well as reduction in market borrowing costs in terms of 10 year G-sec of the Government in the current fiscal from as high as 9.64% at the beginning of the year to 8.06 % at the end of the financial year have helped the State.

Chart 3 :10 Year G-Sec Yield-Kerala



18. The impact of foreign remittance in Kerala economy in general and state finances in particular is to be examined in the changing milieu. In 2013-14 NR deposits, the proxy of the foreign remittance stood at ₹ 93,883 crore. It is about 26.7 percent of Net State Domestic Product. With the addition of remittance the NSDP is modified to ₹ 4,45,128 crore from ₹ 3,51,245 crore. This is 2.5 times higher than the state's Own Revenue, 1.4 times the total expenditure of the Government and is about 82% of the State's total debt. A well planned strategy to tap into these resources will not only help improve the fiscal situation but also provide an affordable supply of funds to finance the major infrastructure projects that the State is proposing.

Table 11 : Impact of Foreign Remittance ₹ in crore

Indicators	2013-14
Remittances	93883
NSDP (at Current prices)	351245
Modified NSDP (at Current Prices)	445128
Per Capita Income (at current Prices) **(in ₹)**	103820
Own Revenue Receipt	37570
Central Transfers	11607
Total Expenditure	66244
State Debt	114477
Remittances as percent of NSDP	**26.7%**
Remittances as percent of Own Revenue Receipts	**250%**
Remittances as percent of Transfers from Centre	**809%**
Remittances as percent of Government Expenditure	**142%**
Remittances as percent of State Debt	**82%**

Source: NR deposits from SLBC Report, NSDP from Economics and Statistics Department

19. In 2015-16 the expenditure is expected to grow by 19.48 % especially capital expenditure as major infrastructure projects in the pipeline is expected to be implemented during this period. The growth of revenue expenditure and capital expenditure is expected to be 14.53 and 24.43 percent respectively. Trend in year-on-year capital expenditure exhibited an upward trend till 2012-13. But in 2013-14, capital expenditure shrank to ₹ 4294.33 crore against ₹ 4603.29 crore.

Table 12 : State Finances

	Accounts					RE	BE
Items	2004-05	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
A. Revenue Receipts	13501	30991	38010	44137	49177	63588	77427
1. State Tax Revenue	8964	21722	25719	30077	31995	38285	45428
2. State Non-Tax Revenue	819	1931	2592	4199	5575	7883	8931
3. Central Govt. Transfers	3718	7338	9700	9862	11607	17420	23068
i) Share of Central Taxes	2405	5142	5990	6841	7469	7926	13122
ii) Grant-in- Aid	1313	2197	3709	3022	4138	9494	9946
B. Capital Receipts	4679	7807	12284	15685	17050	16182	17916
1. Recoveries of Loans	95	44	55	74	104	168	173.2
2. Other Receipts	0	25	16	15	19	25	26.02
3. Borrowings and Other Liabilities	4584	7739	12214	15597	16927	15989	17717
a. Public Debt (Net)	4038	5214	6906	10457	11216	13722	16509
b. Public Account (Net)	546	2525	5308	5140	5711	2267	1207
C. Total Receipts (A+B)	18180	38798	50295	59823	66227	79770	95343
D. Non Plan Expenditure	14094	31510	41754	48380	55135	62178	73754
1. On Revenue Account	14063	30469	40717	46639	53412	60831	70450
a. Of which Interest Payments	3613	5690	6294	7205	8265	9536	10952
2. On Capital Account	25	598	455	1138	797	939	2901
3.On Loan Disbursements	6	442	582	603	927	407	404
E. Plan Expenditure (including CSS)	3953	7281	9142	10848	11109	17602	21570
1. On Revenue Account	3106	4196	5327	6849	7074	13021	14809
2. On Capital Account	847	2766	3398	3466	3498	4124	6319
3. On Loan Disbursements		319	417	533	538	458	442
F. Total Expenditure (D+E)	18047	38790	50896	59228	66244	79780	95325
1. Revenue Expenditure	17169	34665	46045	53489	60486	73852	85259
2. Capital Expenditure	878	3364	3853	4603	4294	5063	9220
3. On Loan Disbursements		762	999	1136	1464	865	845
G. Revenue surplus/deficit (A-F(1))	-3668	-3674	-8034	-9351	-11309	-10264	-7832
I. Fiscal Deficit (A+B(1)+B(2))-F	-4451	-7730	-12815	-15002	-16944	-15999	-17698
J. Primary Deficit (I-D(1a))	-838	-2041	-6521	-7798	-8679	-6464	-6746

CONTINGENT LIABILITIES

20. As against a legislative ceiling of ₹ 14000 crore in respect of contingent liabilities, the outstanding liabilities as on 31.3.2014 are ₹ 9763.35 crore. Since a number of infrastructure projects are in the pipeline, to facilitate financing of the projects without burdening state budget enhancement of the Government guarantee ceiling to ₹ 21000 cr by amending the Kerala ceiling on Govt. Guarantee Act is on the anvil.

FISCAL POLICIES

21. The perspective plan for 2030 outlines the strategy to help the State grow on par with more advanced regions of the world. The fiscal policy will be centered on this strategy. The fiscal policies of the Government will focus on selected thrust areas which are highlighted in the perspective plan. In summary, the core thrust in fiscal policy in the budget will be the follwoing:

- Restoring the buoyancy in the agricultural sector
- Ensuring critical investments in infrastructure
- Making healthcare affordable to all

- Building a Digital Kerala
- Providing affordable housing for the poor
- Promoting entrepreneurship to boost employment opportunities.
- Fulfilling the agenda of development with care.

▪ Develop sustainable agriculture by increasing productivity and competitiveness is a sine-qua-non for raising incomes and wellbeing of this and future generations. Increasing investments in the agriculture sector with better off take of agricultural credit is one part of this. One broad element of the fiscal policy will be to adopt measures for the rejuvenation of the coconut agriculture sector, which even now is the mainstay of income for a large segment of the population. For this the opportunities offered by Neera as a value added product that can enhance incomes of coconut growers will be tapped. Special emphasis will be given to the revival of the rubber plantation sector through appropriate support mechanisms.

▪ There can be no sustainable growth in the economy without high quality infrastructure. A critical level of investment in infrastructure is necessary to address supply side constraints in the growth equation. For that, Government intends to build a sustainable transport network by developing an inter-modal transport network covering road, rail and water inter-modal transit terminals, up gradation of the inland water way system as a viable alternative mode of transport in the State, airport projects in the State including expansion, major power projects, major port development projects, large water supply projects and four-laning of important segments of high ways in the State. Major infrastructure projects in the pipe line are the Suburban Railway Corridor, Light Metros in Thiruvananthapuram and Kozhikode, Vizhinjam International Deep-water Multipurpose Seaport etc. To address the requirement of resources for major projects, the State will tap into financial markets including NRI remittances.

▪ It is the responsibility of the State to ensure affordable health care to its people, particularly the poor. With this goal, the State will have to ensure a comprehensive health support system which integrates the diverse health care assistance programmes now in operation under different departments and agencies in the State. Such a unified approach will help augment public health sector infrastructure and serve to reduce health costs and out-of-pocket expenditure for the poor in particular.

▪ State will be developed into a knowledge economy where ICT is the keystone. Digital technologies will be used to deliver citizen centric e-governance, health and education hubs, smart cities and villages, intelligent transport systems, applications of ICT in agriculture, land zoning, waste management. Services notified under the Right to Service Act 2012 should be available online to the fullest possible extent. File movement for greater efficiency and speedier delivery of services and redressal of grievances should be achieved through systematic adoption of digital processing of documents viz. E-office software in all offices in the State. This goal should be achieved in phases in the next two years.

▪ Housing for all is not merely a desirable goal but an important ingredient of poverty alleviation strategy. The State will have to invest significantly in providing affordable housing to homeless population particularly the poor. The State will have to design new housing schemes with the participation of local bodies to address this challenge and identify specific approaches like vertical housing, low cost technology and use of prefab construction.

- Develop the industrial sector with importance given to value adoption and adoption of socially and environmentally sustainable processes.
- Develop sustainable forestry by improving both the quantity and quality of forests by adopting and adapting newer and better technologies, better forest management techniques and creating new products out of both forest and non-forest produce.
- Evolve a sustainable livestock strategy coupled with integrated farming by reducing the environmental foot print of farms, while improving milk, meat and eggs production.
- Redefine education strategies to encourage knowledge creation as the overarching goal along with knowledge dissemination
- Adopt and adapt new fishing technologies, adopt new harbor management techniques, improve infrastructure like providing cold storages and cold storage networks, establish hygienic retail markets and increase use of ICT in fishing.
- Develop sustainable tourism in Kerala by integrating tourism with other parts of the economy like medical and health hubs which will attract more stable tourists over a longer period of time and with higher spending capacity.
- Developing a quality work force through providing youth the necessary skills of high order. This strategy will revolve around technology incubation centres developing startup villages to give them opportunities for becoming job providers instead of being mere job seekers.

Tax Policy

22. The Central Government in the budget 2015-16 announced an intent to implement GST in the next fiscal. GST is largely a destination based tax. Hence the State expects that this will help it better to augment resource mobilization through improvements in the administrative measure for tax collection. Several measures by way of increasing tax rates selectively including cancellation of all stay orders will help reap the fruits of improved tax collection efforts.

Fiscal Outlook for 2015-16 to 2017-18 : Three Year Rolling Targets And Underlying Assumptions

23. The State is determined to consolidate the fiscal position by revenue augmentation and rationalization of expenditure. The additional inflows from the recommendations of the 14th FC will also give leverage to consolidate the fiscal situation while the commensurate decline in plan transfers will pose serious threats to the fiscal health of the State and impair its ability for undertaking the much needed capital expenditure24. The 14th FC has proposed certain fiscal consolidation targets. Though the recommendation has not been accepted by the union government yet and subsequent amendments in fiscal responsibility legislation does not seem to be imminent, the state shall take serious steps to follow the recommendations in letter and spirit for the better fiscal management.

Table 13: Fiscal Rules proposed by 14th FC

	2015-16	2016-17	2017-18	2018-19	2019-20
RD/GSDP	0	0	0	0	0
FD/GSDP	3	3	3	3	3
IP/RR	15.70	15.01	14.37	13.78	13.23
Debt/GSDP	31.34	30.84	30.40	30.01	29.67

24. Regarding the above ratios, the debt-GSDP ratio is already under limit and the target can be achieved without any difficulties. It is also presumed that the Interest Payment/Revenue Receipts ratio can be brought under the level. But the other two indicators will more difficult for the State to achieve. The pre-devolution revenue deficit and concomitant revenue deficit grant proposed by the Finance Commission is without reckoning the salary component of revenue expenditure and the impact of quinquennial pay revision in the state. Even though it is not possible to eliminate Revenue deficit altogether, it can be brought under control. Since RD is the major component of FD and state is planning for huge investments in infrastructure, it will be difficult to achieve the FD/GSDP targets either. The possible outcome of the rolling targets is as below.

Table 14: Fiscal Indicators-Rolling Targets

	2014-15RE	2015-16 BE	2016-17	2017-18
			Forward Estimates	
RD/GSDP	2.07	1.37	1.26	1.06
FD/GSDP	3.22	3.10	3.09	3.01
Debt/GSDP	25.86	25.42	25.24	25.01
IP/RR	15.00	14.15	12.49	11.61

Assumptions underlying the Fiscal Indicators

GSDP

25. In the national level GDP at factor cost is replaced by GVA at basic prices and GDP at market prices is termed as GDP. In the state level GSDP has been calculated at factor cost .Now the union government in its current budget proposals has used GDP (base 2011-12=100 at market price) for determining all indicators. However the base revision process in the state is underway. Hence in line with the national trend GSDP at market prices (base 2004-05=100) (henceforth referred as GSDP) is used for determining the indicators. The Economic and Statistics Department has estimated the GSDP as follows

Table 15: GSDP at Market Prices(Base 204-05=100)

	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16
GSDP (MP)	286834	339716	379417	430211	496886	570523
Growth		18.44	11.69	13.39	15.5	14.82

26. The Compounded Average Growth Rate (CAGR) of GSDP is 14.74%.Hence the forward estimates of GSDP is projected with this growth rate.

Revenue Receipts

State's Own Revenue

27. State's Own Tax Revenue comprises both tax and non-tax revenues. Even though the tax collections show some sluggish growth in the last fiscal, the outlook for the coming years is more optimistic given the earnest efforts of the Government and additional leverage to be obtained due to the introduction of GST. Hence tax is projected with the CAGR for the period of 2010-16 of 15.90% and non-tax is projected with the CAGR for the period of 2010-14 (actuals are available for the period) of 42.39%

Central Transfers

28. Central transfers comprises Finance Commission devolutions and Plan transfers. Even though the Finance Commission devolutions for the fiscal 2016-17 and 2017-18 are ₹21599.05 crore and ₹22589.36 crore respectively. The proposed GST will likely enhance union tax collections and therefore the

quantum of transfers to the States will be increased. However from the Union Budget 2015, it is clear that the plan transfers will be diminished in the future. By considering the above factors central transfers is projected at 25.74% for forward estimates.

Non Debt Capital Receipts

29. Non Debt Capital Receipt is projected at a CAGR of 21.23%

Revenue Expenditure

Salary and pension

30. It is expected that 10th pay revision is implemented in 2015-16 fiscal and corresponding amount is earmarked for pay and pension revisions. Hence the pay and pension amounts are projected by using the CAGR of the period of which accounts are finalized. Accordingly pay is projected with a CAGR of 20.45% and pension is projected with a CAGR of 20.02%.

Interest Payments

31. Interest is calculated on the midyear debt, reckoning effective interest rate at 7.60% which is observed annually for the past 5 years, for the forward estimates period.

Devolution to LSGI's and Subsidy

32. Devolution to LSGIs are calculated on the basis of the CAGR of 25.88% which may be in accordance with the likely recommendations to be made by the 5th State Finance Commission. Subsidy is also projected with a CAGR of 26.13%

Capital Expenditure

33. The Government is planning for major infrastructure investments in the coming years. Hence Capital Expenditure is projected with capital outlay growth of 21% and loan disbursement CAGR of 24.32%

34. All other items are projected with corresponding CAGR for the period 2010-14.

Table 16: Medium Term Fiscal Plan

Item	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
	Accounts	Accounts	Accounts	Accounts	RE	BE	Forward Estimates	
Revenue Receipts (RR)	30991	38011	44137	49177	63588	77427	94374	115602
Own tax revenue	21722	25719	30077	31995	38285	45428	52651	61023
Non Tax Revenue	1931	2592	4198	5575	7883	8931	12717	18108
Resources from Centre	7338	9700	9862	11607	17420	23068	29006	36472
Non Debt Capital Receipts	69	71	88	123	193	199	242	293
Revenue Expenditure	34665	46045	53489	60486	73852	85259	102643	123572
Salaries	11032	16029	17257	19280	22025	26594	32032	38583
Pensions	5767	8700	8867	9971	11515	13172	15809	18974
Interest	5690	6294	7205	8265	9536	10952	11790	13417
Subsidies	624	1002	1265	1252	1109	852	1075	1355
Devolution to Local Governments	2971	3897	4739	5926	7507	7665	9648	12145
Other Revenue Expenditure	8581	10123	14156	15791	22161	26024	32290	39098
Capital Expenditure	4126	4852	5739	5759	5928	10066	12208	14918
Capital Outlay	3364	3853	4603	4294	5063	9220	11156	13611
Loan disbursements	762	999	1136	1464	865	845	1051	1307
Revenue Deficit (+) / Surplus (-)	3674	8034	9352	11309	10264	7832	8270	7970
Fiscal Deficit (+) / Surplus (-)	7731	12815	15003	16944	15999	17698	20236	22595
Primary Deficit (+) / Surplus (-)	2041	6521	7798	8679	6464	6746	8446	9178
Debt Stock	78673	89418	103561	114777	128499	145009	165244	187839
Government Guarantees	7426	8277	9100	9763	11163	11946	12783	13679
GSDP (at Market Prices)	286834	339716	379417	430211	496886	570523	654618	751109
Interest / RR (%)	18.36	16.56	16.32	16.81	15.00	14.15	12.49	11.61
Debt / RR (%)	253.86	235.24	234.64	233.40	202.08	187.28	175.10	162.49
RD / RR (%)	11.86	21.14	21.19	23.00	16.14	10.12	8.76	6.89
RD/GSDP (%)	1.28	2.36	2.46	2.63	2.07	1.37	1.26	1.06
RD/FD (%)	47.52	62.69	62.33	66.74	64.15	44.25	40.87	35.27
FD/GSDP (%)	2.70	3.77	3.95	3.94	3.22	3.10	3.09	3.01
Debt Stock/GSDP (%)	27.43	26.32	27.29	26.68	25.86	25.42	25.24	25.01
Nominal GSDP Growth Rate (%)		18.44	11.69	13.39	15.50	14.82	14.74	14.74
Average Interest Rate (%)		7.49	7.47	7.57	7.84	8.01	7.60	7.60
Domar Gap		10.95	4.22	5.82	7.66	6.81	7.14	7.14