

ILLUSTRATION: ROHINT PHORE

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STATE FINANCES

Fiscal space before the new govt in Karnataka

As of now, the fiscal indicators of Karnataka are well within the fiscal rules framework—although public debt is on the rise, it is within the 20% threshold limit in terms of GSDP. How the Fifteenth Finance Commission's decision on tax transfers and grants-in-aid will affect state finances—given its stagnant revenue buoyancy—is something to look forward to

KARNATAKA IS THE first state in the country to have introduced a fiscal rules framework, even before the central government had enacted the Fiscal Responsibility and Budget Management (FRBM) Act, 2003. The Karnataka Fiscal Responsibility Act (KFRA) was enacted in 2002, and the trends in deficit of the state over the years have revealed that Karnataka is fiscally-prudent with its revenue deficit-to-GSDP ratio consistently reducing to near-zero and the fiscal deficit-to-GSDP ratio is consistently below 3% (see table).

It is also interesting to recall here the Fourteenth Finance Commission (FC-XIV) recommendations that extra-borrowing powers would be provided to the states, had the states been meeting certain fiscal criteria. If a state, for instance, maintains a fiscal deficit of 3% of GSDP for the award period (2015-16 to 2019-20) and phase-out of revenue deficit, it is eligible for extra-borrowing powers up to 0.25% of GSDP. Further, if a state has reduced the interest payments-to-revenue receipts ratio to 10% in the preceding year and the public debt-to-GSDP ratio stands at 25%, it can get additional borrowing limit of 0.25% of GSDP in the given year. This policy framework became operational from April 2016 onwards. The fiscal indicators for Karnataka are well within these threshold limits.

In 2016, the FRBM Review Committee was set up. The FRBM Review Committee report 2017 recommended a transition in the fiscal rules from deficit to debt, with a cap on public debt-to-GSDP ratio at 60%, with 40% at the Centre and 20% at the states, unless an "escape clause" is invoked due to any "exceptional circumstances" including unanticipated fiscal implications of structural policies and natural calamities

(Chapter 8, FRBM Committee Report, 2017, Volume 1, pages 127-130).

The KFRA was not amended incorporating these recommendations. But the articulation of the "escape clause" within the fiscal rules is an area the state can explore within the Medium Term Fiscal Framework, against the backdrop of devastating floods in north Karnataka.

How the state has achieved fiscal prudence is interesting to examine, whether it is through revenue buoyancy or through expenditure compression? The tax-to-GSDP ratio of the state is not increasing; it is around 7% of GSDP. The revenue from non-tax sources is also declining, and it is less than 1% of GSDP.

The intergovernmental fiscal transfers (both tax transfers and grants) form only around 30% of the revenue receipts of Karnataka. The central tax transfers have shown an increasing trend, especially after the FC-XIV. In fact, Karnataka has gained due to a change in the horizontal devolution formula by the FC-XIV incorporating the state's net forest cover with 7% weightage. The grants-in-aid provided by the FC-XIV were for the local bodies (both rural and urban) and the disaster relief grants.

As around 70% of state finances come from own revenue resources, has the declining buoyancy in "own revenue" prompted the state to go for selective expenditure compression to maintain fiscal prudence? Examining the expenditure side, we found no visible indication of expenditure compression in the state at the aggregate level. In Karnataka, around 80% of total expenditure is on revenue account (committed expenditure), so the ratio of committed expenditure to revenue receipts is around 80% in Karnataka. Over the period 2011-12 to 2019-20, the revenue spending and capital spending in the state has been around 12% and 2% of GSDP, respectively, giving the total "size of the government" to about 14% of GSDP.

When we examined the disaggregated components of expenditure, the social sector spending constitutes around 39% of total spending. However, within the social sector, education spending is only around 13% of total spending. Over the years, the spending on education in the state has shown a marginal decline as well. This points out that the state needs to prioritise on education. The public spending on health remained constant in Karnataka—around 4% of the total budget. Within the social sector budget of Karnataka, our analysis revealed a clear re-prioritisation of spending from education and health

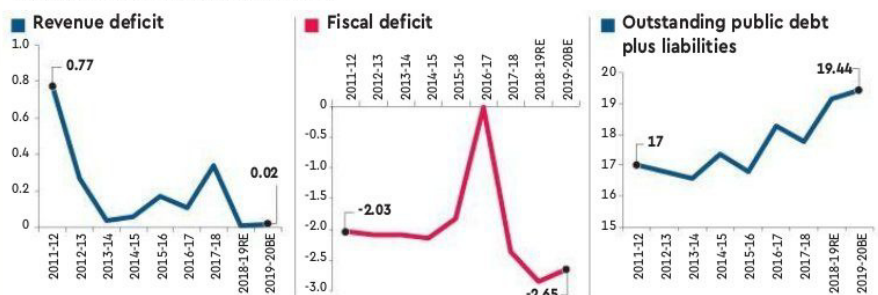
to water and sanitation.

Analysing the fiscal space of Karnataka is compelling against the political economy backdrop of the recent change of the government. The new fiscal priorities in Karnataka are not yet clear. Given the tight fiscal prudence revealed from the analysis above, Karnataka seems to have no room for expanding its fiscal space. The low share of capital spending can have adverse growth consequences in the long term.

The few populist announcements that are on board (including the additional relief of Rs 4,000 promised to the beneficiaries of the Pradhan Mantri Kisan Samman Nidhi yojana, and the waiver of outstanding loans taken by weavers) can derail the prudent public finances of the state.

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Debt and deficit (% of GSDP)



Source: NIPFP databank on Finance Accounts and Budget, Karnataka (various years)

