CHAPTER 1

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1.1 Public Expenditure

Public expenditure is the value of goods and services bought by the State and its articulations. Public expenditure plays four main roles:\1:

1. it contributes to current effective demand;

2. it expresses a coordinated impulse on the economy, which can be used for stabilization, business cycle inversion, and growth purposes;

3. it increases the public endowment of goods for everybody;

4. it gives rise to positive externalities to economy and society, the more so through its capital component.

With its prioritised structure and its peculiar decision-making processes, it substantiates the prevailing kind of State. In a democracy, public expenditure is an expression of people's will, managed through political parties and institutions. At the same time, public expenditure is characterised by a high degree of inertia and law-dependency, which tempers the will of the current majority. Public

\1 Valantino Piana in "Public Expenditure", Economics Institute, 2001; (http://www.economicswebinstitute.org/institute.htm/Okt.18, 2006)
expenditure can be financed through taxes, public debt, money emission, international aid.

Composition

First, public expenditure can be classified in terms of the kind of goods and services bought, also with very general items:

1. capital goods;
2. consumption goods;
3. personnel expenditure.

By contrast, public expenditure in national accounts does not comprehend mere transfers among social groups, as it is the case in pension schemes. Payments of interest on public debt are not comprehended as well.

Second, public expenditure can be classified according to the official body and organization from which budget it is paid, as for example:

1. the central state and its ministries;
2. regional and local authorities;
3. separate public bodies;
4. international organizations.
Here we should note that public expenditure usually does not consolidate state-owned firms. Their capital goods expenditure is added to investment.

Third, public expenditure can be classified according to the macro-function at which it is directed:

1. justice and public order;
2. infrastructure (roads, railways,...);
3. military system;
4. education system;
5. health care;
6. support for the poor, the old, the disadvantaged;
7. support for firms, export and production in general;
8. special policy expenditure (foreign aid, integrated fight against drugs,...).

In different places and over time, those macro-functions have largely changed their level of priority and even the social acceptance of the idea that it is the State that must take care of them. In particular, as a very sketched framework, one may distinguish at least three general models of state to which public expenditure corresponds:
1. the minimal state, where only justice, public order, foreign policy and some other basic functions should be carried out by the state, relying on private initiative for the others;

2. the welfare state, where the State cares about the people's well-being directly, also through expenditure in schooling, health, support for the poor, the old, the disadvantaged;

3. the developmental state, where the State takes the responsibility of fostering economic development, also through expenditure in infrastructure, support for firms, export and production in general.

Both the welfare and developmental state include the items of the minimal state. Military expenditure and special policies are common traits of the three models, maybe in different proportions. Comparing macro-function shares in public expenditure, one can get insights in the kind of state under analysis. Needless to say, the State does not exert its influence on economy and society through public expenditure only, but also for example through laws.

**Determinants**

Public expenditure is determined by political will of the leading forces in the state: their priorities, their desired state model, and their interpretation of current economic and political phase. Past choices have relevant impact on public expenditure because of inertia and incrementalism. Bureaucracy may play an
important decision role for the actual expenditure. Sometimes considered as a completely exogenous variable, the public expenditure would thus be fully in the hand of political decision-makers without dependency from the economic context. Yet, policy makers may turn out to follow an anti-cyclical broad control of public expenditure. Automatic stabilizers may be at work, as with the case of support schemes for unemployment: in this case, higher unemployment and disappointing GDP growth would lead to higher public expenditure through unemployment benefits and financial support to firms. In a different political and institutional context, public expenditure may, instead, positively respond to state revenues. Higher revenues (and maybe even a public surplus) may lead to higher public expenditure. Symmetrically, if there is an upper limit to public deficit and, because of a recession, tax revenue fall, the State may be forced to cut public expenditure. In this context, public expenditure would turn out to be pro-cyclical.

Impact on Other Variables
A GDP component as it is, public expenditure has an immediate impact on GDP. An increase of public expenditure rises GDP by the same amount, other things equal. Moreover, since income is an important determinant of consumption, that increase of income will be followed by a rise in consumption: a positive feedback loop has been triggered between consumption and income, exactly as in the case of shocks in export, investment or autonomous consumption. The full extent of this mechanism will depend, however, on the reactions of the other economic
Firms have to decide whether to increase production or prices in response to demand. Moreover, if consumers interpret the increase in public expenditure as a fall in their disposable income (i.e. after-tax income), consumption may fall accordingly. Public expenditure is also told to crowd out investment, possibly through an interest rate increase, further leading, in a floating exchange rate regime, to a currency appreciation. Exports would then be displaced as well. In more microeconomic terms, public expenditure may be directed to consumer goods and thus substitute families' expenditure, as with the case of health drugs. By contrast, in other cases, as with education, public expenditure may trigger further consumption (books and all the other goods whose consumption depend on culture levels).

Long-term Trends

In developed countries, it has always grown, whatever the political orientation of the government. Just the tempo can change. With a few exceptions, only under extremely strong constraints has public expenditure been cut in absolute terms. Wars are episodes of extremely high public expenditure, followed usually by a return to normality.

Business Cycle Behaviour

Public expenditure may turn out to be pro-cyclical or anti-cyclical depending on the political and institutional attitude toward public deficit. Still, real world data shows often little reaction of public expenditure to the cycle. Most cycles show
Public expenditure as a stabilizing tool just keeping the same dynamics when the rest "goes wrong".

1.2 World Bank's Interpretation

According to the World Bank, public expenditure is one of the critical ingredients of a country's development. To make public expenditure efficacious, it is essential that resource allocation decisions are underpinned by sound analysis and that a well designed set of institutions, systems, and a performance focus guide budget formulation and execution.

A country's budget should be a central mechanism in achieving results on the ground. Sustainable poverty reduction will always require informed and well functioning resource allocation processes--due to their impact on macroeconomic stability, the allocation of resources to strategic priorities, and the efficiency and effectiveness with which policies are implemented. Everywhere, public expenditure issues often define the relationship between macro and sectoral concerns and they are where many of the interests of supra national institutions like World Bank and the International Monetary Fund intersect.

A World Bank note prepared by Swarnim Wagle and Parmesh Shah of the Participation and Civic Engagement Group as an issue paper for the Action Learning Program on "Participatory approaches at the Macro level" is reproduced
hersurder to better comprehend the origin of public expenditure and the issues thereto².

The Origin of Public Expenditure

The mainstream public economics literature makes the case that government intervention ought to be considered in two instances, i) when market failures occur because of externalities, public good properties, incomplete information, and lack of competition, or ii) when market activities worsen distribution of income. After establishing at least one of these, the government chooses among a range of instruments to redress the resultant allocative as well as productive inefficiency. The instruments include regulation, tax or subsidy redress, and public-funded private provisioning. In developing countries where absolute poverty, often rural and agro-based, is the biggest development challenge, provision of basic services like primary education and health, infrastructure, income generating and employment activities warrants state involvement for reasons stated. Because public spending is financed by domestic and international taxpayers (in the form of development credit), efficacy of public spending is not only important from a development effectiveness lens, but also because of accountability to the financiers of public spending which includes the poor who pay indirect taxes. That governments step in to correct market failures does not mean, however, that they themselves don’t fail. Their typical constraints are:

² Note No. 69 March 2003, Participation in Public Expenditure Systems - An Issue Paper on Participation in Public Expenditure Systems
**Information constraints:** the distance between the state apparatus and poor people can distort both the content and speed of the flow of information required for effective anti-poverty planning and intervention.

**Capacity constraints:** Even if it was known what ought to be done, states in developing countries may lack the financial and human resources to undertake desired development actions. The Participation and Civic Engagement Team works to promote poverty reduction and sustainable development by empowering the poor to set their own priorities, control resources and influence the government, market and civil society institutions; and influencing governmental and private institutions to be responsive, inclusive, and accountable.

**Incentive constraints:** Unlike the private sector that is primarily guided by pursuit of profits, bureaucratic and political incentives are not as clearly defined, and may be misaligned with development objectives, making anti-poverty interventions less effective. Formal prescriptions to redress these problems include capacity strengthening, decentralization, and institutionalization of accountability systems.

But because past experience has shown that these are inadequate, civic engagement - a process that organizes citizens or their entrusted representatives to influence, share, and control public affairs and development initiatives, implementation and resources - has emerged as an effective complementary
development instrument. It is both a means and an end to better development. It is an end because in open societies democracy ideally encompasses more than the ritual of competitive elections; and it is a means because, subject to conditions, it contributes to redressing some government failures by bridging the information divide, alleviating capacity constraints by making available alternative channels of service delivery, and checking growth of perverse incentive regimes through demands on accountability. The process of civic engagement is additionally potent when it becomes a constructive contributor to an alliance of three most important agents in public policy and management: bureaucratic action, political action, and citizen action.

There are, of course, limitations to what participation can bring, most noteworthy of which are, i) costs in terms of money, time and management, ii) risk of elite capture, iii) possibility of instability, and iv) illegitimate representation. While because of these pitfalls, participatory processes don’t lend themselves to an automatic endorsement in all grassroots activities; a compelling body of empirical evidence exists today which makes a strong case for people’s participation at the micro level. A relevant question to ask now is whether the micro successes can be scaled up to the macro level.

Scaling Up Participation

Attempts have been made in some countries to scale up – or out – processes of civic engagement to the macro level, the domain of adopting, implementing, and
evaluating aspects of socioeconomic policy, e.g., multi-year macro economic packages (Ireland), municipal budget formulation (Brazil), and civic evaluation of public sector performance (India). Here, while the evidence is not as conclusive as at the micro level because country specific experiments vary in scope, and outcomes are preliminary. But there are encouraging results in some areas. Public expenditure management - systems that deal with the collection and allocation of public resources, is one of them, especially in view of the biggest development goal of the new century, which is to reduce absolute levels of poverty for over 1.3 billion people, mostly in Africa and South Asia. If financial resources are a necessary but insufficient ingredient for modern socio-economic development, then the first question to ask, even before exploring options for increasing the volume of resources is whether governments use existing resources prudently or not. Are resources being targeted to the right sectors? Do they flow to the designated sectors? Should they be flowing to the sectors in the stipulated amounts at all? In other words, all good public expenditure systems must pass the test of accounting, monitoring, auditing and evaluating on a sustained basis. It is then that participation becomes an integral component in public expenditure management because citizen's engagement can assist in processes that lead to better targeting, allocation, and tracking of resources. They can also help in reconfiguring sets of development policy choices. Tools of public expenditure, like national budgets, are themselves important policy statements expressed in money terms. However, beyond the development
effectiveness argument, the issue for participation in PE is also one of accountability.

Accountability as a Citizen Right

Guided by ideological or other policy choices, governments may be active in areas not necessarily characterized by market failures. Irrespective of motivations, governments universally tax citizens to undertake expenditures on their behalf. Since the beginning of civilization, taxes have been the most practical way of revenue generation to finance public spending. Taxes are raised domestically, although they may also be received in the form of international transfers from taxpayers in other countries as is the case with development lending. Because most sources of government spending are citizen entitlements, in money or in kind, a basic case can be made to see transparent accounting of public expenditures as not only a means to an efficient development outcome, but also as a fundamental citizen right - an end in itself.

Reforming Public Expenditure Systems

Budgets -- national, provincial or municipal - represent a government's statement of expected revenues and expenditures over a period of time. While poverty can be reduced through multiple channels (such as growth spurred by private investment) public spending in basic service provisioning remains one of the most direct instruments. Further, budgets serve numerous socio-economic purposes by allocating resources in ways that promote or hinder growth and
equity. Despite this overarching importance, budgets in developing countries have not been as effective as they should be. This is why the agenda to reform public expenditure systems has been given such a high priority. As the World Bank's Poverty Reduction Strategy Sourcebook summarizes, a number of urgent technical reforms needed in existing PE systems include the following:

Better resource planning: a longer term planning horizon where policy choices are disciplined by realistic resource availability. Government programs should compete for funding, not rely on routine increments. Cost Analysis of public projects ought to be a reiterated exercise.

Better accounting, auditing and procurement: a transparent process of formulation, approval, implementation and reporting among the formal institutions – the cabinet, finance ministry, line ministries, office of the auditor generals is a primary requirement. This should be complemented by information disclosure and press freedom laws.

Better performance: allocation alone does not ensure impact. Greater link between resources and performance guided by measurable indicators. Formal institutional remedies of this kind are necessary to strengthen national public expenditure systems, and this has been the focus of most public sector reform programs. But incorporating elements of civic engagement to complement these institutional reforms has so far been an under-appreciated and under-tried
innovation. Drawing on a number of successful cases and tested models from around the globe, a framework for Participatory Public Expenditure System is presented, where civic groups influence stages of the budget process in a cyclic and iterative manner. The framework proceeds with a caveat that what is sought is not an ad-hoc institution of a participatory channel that subverts established politico-legal processes which have constitutional recognitions, but draw on inputs that civic engagement affords to make the public expenditure system more transparent, accountable, and efficient toward the end of poverty reduction.

Participation In Public Expenditure Management
This spans four key stages in a cyclic manner: Formulation, Analysis, Expenditure Tracking, and Evaluation.

**Formulation:** When revenue and expenditure estimates are being prepared, processes of civic engagement can influence how the expenditure proposals are made – to which sectors and in which amount. But opening up the formulation process also helps the government present policy and resource options to the public, so that participation simply doesn't create a wish-list of conflicting demands or over expectations.

**Analysis:** Once the ramifications of the expenditure proposals are known, the next thing obviously has to be analysis. Analysis can render participation in public expenditure management more meaningful and optimise the benefits
flowing from public expenditure. The analysis has to be objective and in line with established practices in the field. It should stand scrutiny even by international bodies like World Bank, International Monetary Fund, Asian Development Bank, etc.

Expenditure Tracking: Analysis leads to expenditure tracking and more often than not the latter leads to the former. Irrespective of which leads to which, it has to be admitted that expenditure tracking helps in avoiding known pitfalls, fine-tuning existing measures and drawing up realistic goals. Expenditure tracking helps immensely in comparative analysis too. Even internationally, expenditure tracking is regarded as important as expenditure incurring for this reason.

Evaluation: Last but not least is evaluation which none can afford to ignore. It is through evaluation the effectiveness of the measures implemented can be gauged. It is again through evaluation that one can conclude if the sacrifice on the part of the people and the government is worth the results that the said sacrifice has succeeded in generating. The evaluation methodology itself has been a subject of immense debate in informed circles and consensus on the methodology to be applied is yet to evolve. Be that as it may, evaluation methodologies have evolved over a period of time, with each methodology offering its own set of merits and demerits. The methodology that a particular government chooses is influenced by national peculiarities and preferences. Thus across the comity of nations, it will not be identical.
1.3 David Heald and Alasdair McLeod's Interpretation

In broad terms, public expenditure is a simple concept: it denotes the dispensation by the state, on non-market criteria, of economic resources that it has acquired from firms and households. However, the detail is highly complex because the modern state is such a difficult concept to analyse. Consequently, care is always required in the interpretation of public expenditure figures, particularly when these become the subject of heated political debate.

Although much used in theoretical discussions in economics and political science, the term 'state' is infrequently used in political debate in the United Kingdom. Instead, the term 'government' is used, with distinctions made between central government and local authorities which, taken together, constitute the 'general government' sector in the national accounts. This brings precision at one level: there is an operational list of organisations that fall within the national accounts' definition of general government. But there is a wide range of other organisations, including public enterprises (that is, commercial trading businesses) and a host of ad hoc bodies established by government to undertake certain kinds of activities and expenditure. The decisions as to whether and, if so, how such bodies are consolidated into public expenditure aggregates have major implications for the declared public expenditure totals. Bodies that are effectively

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1 In the economic and political science literature, this word is used both abstractly and as a synonym for government or public power. In India, frequently the term 'government' is used, with distinctions made between central government and state governments which, taken together, constitute the 'general government' sector.
controlled by central government and rely on it for most of their funding are generally classified as part of central government.

There can, however, be considerable argument about where the public sector (general government plus public corporations) ends and the private sector begins. The term 'quasi public sector' is used by academics, though not by official statisticians, as an umbrella term for organisations that are so 'close' to government (whether by virtue of financial dependency or effectively being under its control) that it becomes misleading to exclude them from consideration of the public finances. Universities and housing associations, both nominally private, are obvious examples. Nevertheless, following conventional practice, most of the material in this chapter relates to either general government or the public sector.

Exhaustive public expenditure (that is, expenditure on goods and services) should be carefully distinguished from transfer payments. The key difference is that, in the former, the state takes decisions about the pattern of final output. Decisions have to be taken about both scale (that is, expenditure totals) and composition (for example, the relative priorities attached to defence and education). On the input side, the market is generally maintained, with the state bidding for factors of production in competition with firms and households. However, certain markets for public sector inputs may be distorted by the state's monopoly power and the monopoly power of unionised public employees.
In the case of transfer payments, the state redistributes purchasing power from the hands of one group of individuals (taxpayers) to those of another group (beneficiaries). The composition of final output depends upon the consumption decisions of individual recipients, thereby respecting consumer sovereignty. Decisions about the scale of such compulsory redistribution of purchasing power must be taken through political processes. It is difficult to map the resulting highly-complex patterns in a welfare state: from the young to the old; from the more affluent to the less affluent; and the considerable amount of ‘churning’ that takes place (that is, the same individual simultaneously pays tax and receives benefits).

At any given level of public expenditure, there are important choices between policy instruments that lead to exhaustive public expenditure and those that involve transfers. Public expenditure figures in an industrialised economy are huge in absolute terms, and comparisons between years are naturally affected by changes in price levels. For the purpose of analysis, public expenditure data is often either converted into constant price terms or measured in relation to a macroeconomic aggregate such as Gross Domestic Product (GDP).

1.4 Public Expenditure in the Indian Context

Under Article 112 of the Constitution, a statement of estimated receipts and expenditure of the Government of India has to be laid before Parliament in respect of every financial year which runs from April 1 to March 31. This
statement titled `Annual Financial Statement' is the main Budget document. The Annual Financial Statement shows the receipts and payments of the Government under the three parts in which government accounts are kept: i) Consolidated Fund, ii) Contingency Fund; and iii) Public Account.

All revenues received by the Government, loans raised by it, and also its receipts from recoveries of loans granted by it, form the Consolidated Fund. All expenditure of the Government is incurred from the Consolidated Fund and no amount can be withdrawn from the Fund without authorisation from Parliament.

Occasions may arise when the Government may have to meet urgent unforeseen expenditure pending authorisation from Parliament. The Contingency Fund is an imprest placed at the disposal of the President to incur such expenditure.

Parliamentary approval for such expenditure and for withdrawal of an equivalent amount from the Consolidated Fund is subsequently obtained and the amount spent from Contingency Fund is recouped to the Fund.

Besides the normal receipts and expenditure of the Government which relate to the Consolidated Fund, certain other transactions enter government accounts, in respect of which, the government acts more as a banker, for example, transactions relating to provident funds, small savings collections, other deposits,
and so on. The monies thus received are kept in the Public Account and the connected disbursements are also made therefrom. Generally speaking, Public Account funds do not belong to the Government and have to be paid back sometime or the other to the persons and authorities who deposited them. Parliamentary authorisation for payments from the Public Account is, therefore, not required.

In a few cases, a part of the revenue of the Government is set apart in separate funds for expenditure on specific objects such as sugar development, replacement of depreciated assets of commercial undertakings, and so on. These amounts are withdrawn from the Consolidated Fund with the approval of Parliament and kept in the Public Account for expenditure on the specific objects. The actual expenditure on the specific objects is, however, again submitted for vote of Parliament even though the monies have already been earmarked by Parliament for transfer to the funds.

Under the Constitution, Budget has to distinguish expenditure on revenue account from other expenditure. Government Budget, therefore, comprises i) Revenue Budget; and ii) Capital Budget.

Revenue Budget consists of the revenue receipts of Government (tax revenues and other revenues) and the expenditure met from these revenues. Tax revenues comprise proceeds of taxes and other duties levied by the Union.
The estimates of revenue receipts shown in the Annual Financial Statement take into account the effect of the taxation proposals made in the Finance Bill. Other receipts of Government mainly consist of interest and dividend on investments made by the Government, fees, and other receipts for services rendered by the Government. Revenue expenditure is for the normal running of Government departments and various services, interest charges on debt incurred by the Government, subsidies, and so on. Broadly, expenditure which does not result in creation of assets is treated as revenue expenditure. All grants given to State Governments and other parties are also treated as revenue expenditure even though some of the grants may be for creation of assets.

Capital Budget consists of capital receipts and payments. The main items of capital receipts are loans raised by the Government from public which are called market loans, borrowings from the RBI and other parties through sale of Treasury Bills, loans received from foreign governments and bodies and recoveries of loans granted by the Central Government to State and Union Territory governments and other parties. Capital payments consist of capital expenditure on acquisition of assets such as land, buildings, machinery, equipment, as also investments in shares, and so on, and loans and advances granted by the Central Government to State and Union Territory governments, government companies, corporations and other parties. Capital budget also incorporates transactions in the Public Account.
Accounting Classification

The estimates of receipts and disbursements in the Annual Financial Statement and of expenditure in the Demands for Grants are shown according to the accounting classification prescribed under Article 150 of the Constitution. This classification is intended to allow Parliament and the public to make a meaningful appreciation of allocation of resources and purposes of government expenditure.

Under the Constitution, certain items of expenditure such as emoluments of the President, salaries and allowances of the Chairman and the Deputy Chairman of the Rajya Sabha and the Speaker and the Deputy Speaker of the Lok Sabha, salaries, allowances and pensions of judges of the Supreme Court and the Comptroller and Auditor-General of India, interest on and repayment of loans raised by Government and payments made to satisfy decrees of courts, and so on, are charged on the Consolidated Fund and are not required to be voted by the Lok Sabha.

The Annual Financial Statement shows the expenditure charged on the Consolidated Fund separately.

Demands for Grants

The estimates of expenditure from the Consolidated Fund included in the Annual Financial Statement and required to be voted by the Lok Sabha are submitted in the form of Demands for Grants in pursuance of Article 113 of the Constitution.
Generally, one Demand for Grant is presented in respect of each Ministry or Department. However, in respect of large Ministries or Departments more than one Demand is presented. Each Demand normally includes the total provisions required for a service, that is, provisions on account of revenue expenditure, capital expenditure, grants to State and Union Territory governments and also loans and advances relating to the service.

In regard to Union Territories without Legislature, a separate Demand is presented for each of the Union Territories. Where the provision for a service is entirely for expenditure charged on the Consolidated Fund, for example, interest payments, a separate Appropriation, as distinct from a Demand, is presented for that expenditure and it is not required to be voted by Parliament.

Where, however, expenditure on a service includes both `voted' and `charged' items of expenditure, the latter are also included in the Demand presented for that service but the `voted' and `charged' provisions are shown separately in that Demand.

The Demands for Grants are presented to the Lok Sabha along with the Annual Financial Statement. Each Demand first gives the totals of `voted' and `charged' expenditure as also the `revenue' and `capital' expenditure included in the Demand separately and also the grand total of the amount of expenditure for which Demand is presented. This is followed by the estimates of expenditure
under different major heads of account. The break up of the expenditure under each major head between 'Plan' and 'Non-Plan' is also given. The amounts of recoveries taken in reduction of expenditure in the accounts are also shown.

A summary of Demands for Grants is given at the beginning of this document, while details of 'New Service' or 'New Instrument of Service' such as formation of a new company, undertaking or a new scheme, and so on, if any, are indicated at the end of the document.

**Finance Bill**

The proposals of the Government for levy of new taxes, modification of the existing tax structure or continuance of the existing tax structure beyond the period approved by Parliament are submitted to Parliament through the Finance Bill.

The Budget documents presented in terms of the Constitution have to fulfil certain legal and procedural requirements and hence may not by themselves give a clear indication of the major features of the Budget.

To facilitate an easy comprehension of the Budget, certain explanatory documents are presented along with the Budget.
1.5 Classification of Public Expenditure

The theory of public expenditure is categorised under three heads, viz., normative theory, positive theory and applied theory, each dealing with different aspects of public expenditure. The theory of public expenditure answers questions like what should be the appropriate level of expenditure, what is the behaviour and composition of the prevailing expenditure and lastly what are the

Normative Theory

Normative theory of public expenditure deals with prescribing norms for a given level of expenditure. Norms are prescribed in order to attain the so-called ideal conditions of allocation and distribution. Failure of the market to provide certain goods and services, has added to the importance of decision-making by the government. The increased importance of the exercise has drawn the attention of many economists who have tried to define the norms to bring about the right level of government activity in terms of expenditure and receipts. In this context, various issues with normative overtures have been debated by the economists. The important ones constitute issues like social choice, concept of public goods and pure theory of public expenditure. The latter discusses the norms for allocation and distribution of resources.
Social Choice

Social choice pertains to the analysis of actual public policy decision process. There are basically three approaches to the formation of public policies:

- Pure individualistic approach
- Pure collective approach
- Para individualistic approach

Pure Individualistic Approach

This approach vests the power of public policy formulation with the individuals. Hence consumer sovereignty becomes the base for the theory of public sector. This has been developed in the tradition of Pantalooni (1964) which states that social choice must be based on individual choice and thus public policies should be made according to individual preferences. Accordingly government institutions and political elites are motivated by individual choices and thus they have not been assigned an independent role. Pure individualistic approach has also been adopted by Musgrave (1959) and Samuelson (1954) in arriving at normative solutions for the allocation and distribution of resources.

Pure Collective Approach

Contrary to the pure individualistic approach, this approach underlines the importance of collective institutions in formulating public policies. This has been developed in the tradition of Montemartini (1964) and according to it, the political
Authority is assigned the responsibility of deciding on public expenditure and thus takes up the responsibility of formulating a general welfare policy. Hence it is possible that the public sector policies may not reflect the preferences of individuals but nevertheless public interest is often taken note of. This approach has been used by a number of authors like Colm (1955) and Wildvsky (1964) in their writings.

Para Individualistic Approach

According to this approach, public policies are an outcome of the interaction between two self-interested groups, viz., collective fiscal institutions, as the suppliers and the individuals as the voters. Here too, consumer sovereignty plays a role in decision making but at the same time collective institutions also have an equally important or even a greater role to play in decision-making. This approach is also known as self-interest approach because the social choice results from the pulls and pressures of the two self-interested groups, viz., the individuals or the voters who try to maximise their satisfaction and on the other hand, the collective political institution which tries to enhance its interest in terms of either remaining in power or getting re-elected. Downs (1957), Buchanan (1948, 1960, 1967), Buchanan and Tullock (1962) and McKeen (1965, 1968) have based their analysis of para individualistic approach.
Concept of Public Goods

The second important aspect widely discussed in normative theory is the failure of the markets in providing certain goods and services. Public expenditure has gained in importance because of the fact that the private sector fails to provide certain services of prime importance.

Market failure to produce certain goods and services has been attributed to many reasons. Head states ‘non-appropriability of benefits’ as one reason for market failure. He defines non-appropriability as ‘that property of a good which makes it impossible for private economic units to appropriate by ordinary private pricing, the full social benefits from their production and / or consumption of that good’ (Head, 1972).

Transaction cost is another cause cited by Arrow (1951, 1970) for the failure of the market. In case of certain goods, recovering the cost from the market or the beneficiaries poses a problem due to the spill over effects. Hence it becomes a very costly phenomenon to obtain the information needed to enter and participate in the market. It is stated that because of the high transaction costs, the market does not participate in producing such goods and services thus giving room for government intervention.

Another reason for the failure of market to provide public goods as cited by Samuelson (1954) is the joint nature of public goods supplied and the non-
exclusion principle. Once a public good is produced, any given unit is made equally available to all. Samuelson states that public goods possess the characteristics of consumption externality implying that it enters into the preference functions of two or more individuals at a time. Because of this nature it becomes difficult on the part of the producer to recover the cost incurred.

These unique characteristics of such goods prevent private investors from producing these goods and hence the responsibility to provide these services is largely vested with the respective governments. Hence they have been titled as public goods.

**Pure Theory of Public Expenditure**

Having identified the causes for the growth in relative importance of government, theorists of public expenditure have made an attempt to arrive at the normative solutions for optimum allocation and distribution of the resources. Many have attempted to formulate the theory of public expenditure and the important contributions amongst them are by Samuelson (1954), Lindahl (1958), Musgrave (1959) and Johanssone (1963).

Normative solutions for social choice as approached by Samuelsson and Musgrave are based on the pure individualistic approach. But each differed in the mode in which they tackled the problem. While Samuelson based his analysis on comprehensive general equilibrium approach, Musgrave applied a
partial equilibrium approach. Hence normative solutions have generally been divided into: a) general treatment solutions, b) partial treatment solutions.

a) General treatment solution: It is mainly associated with Samuelson visualises a system with the existence of a polar type of public goods along with those of private goods. Samuelson identifies a situation wherein the planner has the knowledge of preference function for each individual and hence attempts to calculate their demand function for both public and private goods, subject to one's budget constraint. After arriving at the demand functions for each individual, the planner solves it for his utility maximisation. Samuelsson makes the theory clearer by showing the combination of public and private goods which maximise social welfare in his diagrammatic exposition (1955: 350-356).

b) Partial Treatment Solution: Musgrave follows the tradition of Wicksell (1958), Lindahl (19958) in trying to arrive at the normative solutions with the usage of partial equilibrium analysis. Musgrave's theory is well known as "Multiple Theory of the Public Household"
Musgrave expresses doubt over the knowledge of the planner (as assumed by Samuelson) regarding the preference of individuals. In this theory, Musgrave assigns the responsibility of distribution of resources to the distribution branch and allocation of resources to the allocation branch. He assumes that the allocation branch bases its operation on the assumption that distribution of resources is optimised by the distribution branch. This he states is necessary for two reasons: a) unless the state of distribution is given, individuals cannot translate their preferences, whether for private or public wants into a pattern of effective demand; b) unless the given state of distribution can be accepted as the proper one, the resulting pattern of effective demand cannot be accepted in furnishing a guide to the efficient use of resources.

Hence it is the responsibility of the distribution branch to arrive at this optimum level of distribution. In this process, the distribution branch assumes that the satisfaction of public wants is decided correctly by the allocation branch and also that the stabilisation branch maintains full employment and price level stability.
The literature that followed later tried to prove the superiority of one over the other or has made an attempt to club, both general treatment solutions and partial treatment solutions.

However, both the general treatment solution (Samuelson) and partial treatment solution (Musgrave) were put to lot of criticism by the later writers. Both the theories have been criticised on the ground that they are incomplete. Samuelson's work is treated incomplete because he took only exhaustive expenditure and only the economic factors into consideration. It has also been stated that his theory is inoperative. Musgrave's work is treated incomplete because the optimisation in the distribution branch is arrived at on the basis of private goods only. Despite the number of operational difficulties that exist in the normative analysis, it continues to retain its importance in the policy-making.

Positive Aspects

Positive aspects deal with the behavioural pattern of the public expenditure in the past and the present conditions. Positive theory of public expenditure is generally understood as “that body of economic and political analysis which attempts to understand and explain the observed pattern and level of government expenditure and the changes in those expenditures over time” (Bird,
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1970: 6). He states that positive theory of public expenditure comprises of
important subjects (1970:8) like:

- a) The determinants of the volume of public expenditure
- b) The determinants of the composition of public expenditure - what goods
  and services are financed through the public sector and how the 'mix' of
  expenditure changes over time
- c) Such 'behavioural' properties of public expenditure as centralisation and
  stability.

Contributions by Wagner (1967, The Law of Increasing State Activity)\(^4\), Peacock
and Wiseman (The Displacement Effect Hypothesis) and Inter-state variation of
government expenditure by Fabricant (1952) formulate an important portion of
the theory of positive aspects of public expenditure. Other studies which
followed later were an attempt in empirically verifying the Wagnerian and
Peacock and Wiseman's theories and also the determinants of inter-state
variation of government expenditure in the line of Fabricant.

\(^4\) Wagner's contribution was in German, beginning from the period 1863 but the English translation of a
portion of his work is available in R.A. Musgrave and A.T. Peacock (1967) (ed.). *Classics in the Theory of
Public Finance.* - Three Extracts on Public Finance, translated by Nancy Cooke. 1-15. However, a detailed
English version of discussion of Wagner's theory is presented in Peacock and Wiseman (1967) and Bird
Wagner's Law

"Wagner's Law of Increasing State Activity" broadly states that, as the level of economic development attains greater heights, the relative importance of the government sector in the total economic activity increases; on the other hand, governmental expenditure itself increases at a faster rate than that of the per capita income. The summary of his law, in his own words, is that 'the law (of increasing state activity) is the result of empirical observation in progressive countries at least in Western European civilisation; its explanation, justification and cause is the pressure of social progress and the resulting changes in the relative spheres of private and public economy, especially compulsory public economy. Financial stringency may hamper the expansion of state activities causing their extent to be conditioned by revenue rather than the other way around as is more usual. But in the long run the desire for development of a progressive people will always overcome these financial difficulties' (quoted in Peacock and Wiseman, 1967: 17).

Wagner hypothesised an increase in government expenditure on both intensive and extensive scale. Expansion on the intensive scale implies that governments perform the existing functions in a more rigorous way. Extensive expansion means that governments expand their level of activity by undertaking many new functions. This leads to an enormous increase in the level of government expenditure.
He assumes that expansion in the government expenditure takes place under three categories, viz.,

a) The increasing urbanisation which results in increased congestion, law and order problems, gives room for greater government expenditure under the administrative and law and order categories.

b) Secondly, there will an expansion in the provision of services like education, public health, etc, associated with economic growth. Though the reasons for the expansion under these categories are not clearly specified by Wagner, writers who tested Wagner’s theory (Bird, 1970: 70) infer that these are luxury goods for which demand increases with an increase in income.

c) Thirdly, a few economic functions which are characterised by long gestation production processes are generally not undertaken by the private sector and hence there occurs a growth in government expenditure in the area.

Hence by and large, Wagner’s law refers to an expanded government activity brought into force by some factors.

Many expenditure studies conducted later summarised the theoretical considerations underlying ‘the law of increasing state activity’ and some are also
in the nature of empirical verification. Hook (1962) in the case of Sweden has observed that the relative size of public sector increased markedly. Norway and USA were no exception as there was an expansion of public sector with respect to the per capita income as revealed by Johansson (1968) and Gupta (1967) respectively. Emi (1963) finds the same theory operating in the case of Japan during the period 1868-1960. However, the study points out that the period after 1953 was not in consonance with the above contention. The study also brings out that social expenditures have increased at a very fast rate. In case of India too, as observed by Reddy (1972, 1986) and Murthy (1981), Wagner's law is operating.

However, most of the studies have observed that social expenditures are in line with Wagner's argument, whereas the administrative and protective expenditure and the expenditure on the economic categories were not in line with Wagner's argument.

The methods of empirical verification of Wagner's law took different forms in different studies and are grouped into (Gandhi, 1971: 48) five categories. They are:

a) Expenditure and output (Gross National Product) are viewed in absolute terms. The law has been interpreted that with an increase in Gross
National Product (GNP), the expenditure also increases. Elasticity is greater than unity. It is expressed as follows:

\[ E = f(GNP) \]

where \( E \) is expenditure and \( GNP \) is gross national product.

b) Wagner's law has also been verified in terms of relationship between public consumption expenditure and national income. It is expressed as follows:

\[ C = f(Y) \]

where \( C \) is level of government consumption expenditure and \( Y \) is national income.

These two forms are similar in nature in the sense that both expenditure and national income are taken in absolute terms. The only difference is with respect to the type of expenditure considered.

c) In another form Wagner's law is verified by regressing the absolute expenditure on per capita GNP. It is expressed as follows:

\[ E = (GNP/P) \]

where \( E \) is expenditure, \( GNP \) is gross national product and \( P \) is population.

d) The expression was further refined when economists used per capital analysis for both expenditure and GNP. This is expressed as follows:

\[ E/P = f(GNP/P) \]

where \( E \) is expenditure, \( P \) is population and \( GNP \) is gross national product.
e) Since Wagner's theory states that as an economy attains higher levels of development, the relative importance of government activity increases, the later-day economists have preferred usage of the ratio of government expenditure in GNP in order to empirically verify Wagner's law. It is expressed as follows:

\[ \frac{E}{GNP} = f\left(\frac{GNP}{P}\right) \]

where E is expenditure, GNP is gross national product and P is population.

Under all the five forms furnished above, the interpretation would remain the same. Verification is based on the regression coefficients of the following form:

- B>1, is elastic
- B<1, is less elastic
- B=1, is unitarily elastic.

Wagner's law is considered to be operating when the regression coefficient is greater than unity (B>1). However, Wagner's theory was put to a lot of criticism by the later-day economists on the ground that his law was based on the organic concept of state; also that the law had not taken into consideration the time-pattern of growth in public expenditure. Peacock and Wiseman stated, "Even though Wagner himself thought of 'law' as a proposition in the positive theory of public expenditure... his exposition of the law was inextricably entangled with his
own normative assumption as to the nature of the state and of state activity". (Peacock and Wiseman, 1967).

‘Displacement Hypothesis’ of Peacock and Wiseman

Having observed the trends in the United Kingdom government expenditure for the period 1890-1955, the authors emphasised upon the analysis of time pattern of expenditure growth, rather than establishing any generalised theories about the overall trend. It was stated, "we must seek, not universal secular laws, but a way of looking at year-to-year changes in government spending that will not only illuminate the British statistics which are our direct concern but also give us an approach to the subject that might be equally fruitful in studying other countries or periods in interpreting the facts of history or in introducing realism into the discussion of present and future expenditure policies". (Peacock and Wiseman, 1967: 25).

Their analysis revealed that UK expenditure and revenue did not have a uniform growth in their levels; instead, the expenditure was observed to be having sudden spurts and checks. Peacock and Wiseman empirically proved that these kinds of peaks and plateaus were caused by social upheavals such as wars. Government revenue and expenditure reach higher levels during the war periods which did not reach the pre-war level even when the upheaval was over. The authors attributed such behaviour to the tolerable burden of taxation which increased during the war time, thus helping the government to undertake the
functions which it was not in a position to undertake before the upheaval, due to paucity of funds. Their major finding is that although British government expenditure declined after the war, it did not return to the pre-war level and the share of government expenditure in national product remained much greater after the wars than it was immediately before them. This increase in the level of government expenditure with respect to national output has been termed as "Displacement Effect".

As the authors put it, "when societies are not being subjected to unusually violent pressures or disturbances, peoples' ideas about the 'tolerable' burden of government taxation tend to be fairly stable. Governments may, of course, have plans that would increase their expenditure and the plans may be thought desirable by many of the citizens. Nevertheless, their implementation and thus the rate of growth of government expenditure will depend upon the view taken by the government as to the revenues that it is (politically) able to raise as well as upon its own times as to the desirability of increasing government expenditure in any direction" (Peacock & Wiseman, 196: 26-27).

"Displacement Effect" hypothesis was put to large scale empirical testing by the later-day writers. Important among them is that of Gupta (1967) who tried to observe the applicability of "displacement Effect" in case of a number of countries - UK, Germany, USA, Canada and Sweden. Unlike Peacock and Wiseman who have taken wars alone, Gupta has also considered the Great Depression as a
social upheaval along with the world wars. His argument is that even though the tolerable burden of taxation would generally go down at the time of depression, governments would be in a position to spend more because of other sources of government finance like public debt, money creation, etc. Hence he prefers the term ‘tolerable burden of financing to ‘tolerable burden of taxation’.

Gupta criticises Peacock and Wiseman’s hypothesis that since their theory was tested only in case of one country, viz., UK, it cannot be generalised. Secondly, no quantitative measurement and test of significance of the ‘Displacement Effect’ was attempted. Thirdly no attempt was made to test for the significance of shift in the resultant increase in the share of government expenditure in national product after the upheaval.

Gupta has taken care of the above factors in his study and arrives at the conclusion that there was a significant positive shift in the level of government expenditure associated with world war in the case of countries which participated directly in the wars. However, such a shift was associated with the Great Depression only in the case of US and Canada.

Peacock and Wiseman’s work was also criticised on many other grounds. It was stated that ‘the theoretical structure of the displacement effect is even weaker than that of Wagner’s law... is based on a questionable disequilibrium in the
Marshallian sense which even if existed would be harder, if not impossible, to test empirically'. (Afxentiou, 1980:120).

It was also criticised that since the term 'Displacement Effect' was very loosely defined and thus led the later-day writers to use it in a variety of ways. While Gupta (1967), Bonin, et al (1969) included the Great Depression also along with the world wars as an upheaval, Musgrave (1969) and Mann (1975) gave a wider definition to it, wherein they included anything which acted on the attitude of the people towards the government or towards economic development. Based on this it was being criticised that 'this freedom of interpretation lessens the theoretical value of the displacement effect and reduces its empirical testing to an exercise in definition'. (Afxentiou, 1980: 120).

Further, it is important to remember that modern governments are not relying solely on the tax revenue that the government is in a position to raise. Governments also depend on many other sources of revenue like public debt, external aid, deficit financing and many other non-tax resources for the purpose of financing their expenditure; hence any such analysis was to consider the other sources of government finance also. It was also stated that their theory refers to a statement of obvious fact. As Afxentiou puts it "it would indeed be strange if in the long history of countries such turns did not occur and it would similarly be equally strange if these jumps did not result from the deliberate effort of governments to tackle urgently major social problems whose solution frequently
presupposes the expansion of the public sector ... seen in this context
displacement effect is nothing more than an explanation of the obvious”.
(Afxentiou, 1980: 122)

Applied Aspects of Public Expenditure

While normative analysis relates to the formulation of norms to optimise solutions
relating to allocation, distribution, etc., and positive aspect deals with the analysis
of behavioural attitudes, the applied aspects deal with the task of actual decision-
making. Hence the literature pertaining to applied aspects deals with the
functional aspects of public expenditure. It contains the whole gamut of
budgetary process. Of late, one finds that governments have been talking about
fiscal efficiency and thus are advocating the usage of planning – programming –
budgetary system (PPBS). This analytic tool helps the governments to assess
the costs and benefits of various programmes and thus arrive at an efficient
budget which results in efficiency in public spending. Cost-benefit tool is a
simple tool available for decision making wherein a particular action would be
undertaken when it is assessed that the costs involving the action do not exceed
the benefits resulting from that action.

This technique is applied to alternate forms of expenditure in order to arrive at
the efficiency solution. The price of the resources to be employed for the
investment reflects the cost position and the present value of the expected
benefits that accrue in the future represents the benefits.
However, the usage of the cost-benefit analysis poses some problems with regard to measurement of costs and benefits. Firstly it is difficult to arrive at the consumer valuation of the benefits with respect to some of the public goods for which exclusion principle cannot be applied. Secondly the problem is posed by government expenditure that has a significant distributive effect. Thirdly the choice of the discount rate to arrive at the present value of the future benefits poses some problems, since the discount rate is chosen arbitrarily.

However, Musgrave and others point out that no operational difficulties arise with the usage of cost-benefit analysis for the public goods which are in the form of intermediate goods and enter into the production of further output. It is assumed that further output can be valued in terms of the market prices.

However, despite the difficulties that are present, the cost-benefit technique has been made use of successfully to a considerable extent in investments in physical resource development, highway, transportation, etc and in investment in human resource development consisting of education and public health. However one finds that large scale efforts are being put forth by the academicians and other experts to minimise the operational problems posed by the cost-benefit analysis.
1.6 Karnataka

Situated in South West India, Karnataka is one of the leading States in the country in terms of economic development. It is the eighth largest State in terms of both

- Geographical area (1.92 lakh kms)
- Population (5.27 crore - 2001 Census).

The State’s GDP at constant prices (2002-03) at Rs.72,399 crore accounts for 5.5 per cent of the national GDP. The State has witnessed a healthy 6.5 per cent CARG in the GSDP for the ten year period 1994-2003, being the highest among the leading States in the country. The State is largely service oriented and income from the sector contributes to half the State’s GDP with the agricultural and the industrial sector contributing to nearly 25 per cent each. The major manufacturing oriented industries in the State include

- Sugar
- Paper
- Cement industries.
Economy

Karnataka's net state domestic product of $47 billion is the fifth largest in India. Between 1992-2002, Karnataka attracted the fourth highest total Foreign Direct Investment approvals in India, to the tune of Rs. 21,566 million. Karnataka accounts for one third of India's Information technology exports. For the year 2006, the state is expected to bring in 37% of all IT revenues amounting to 37,000 crores ($8.2 billion). Nearly 50% of IT companies and 40% of Bio-Tecnology companies are based here. Agriculture in Karnataka, like most of India, employs 80% of the population. Agriculture and its allied activities account for 49% of the state's income. The coastal plains of Karnataka, which include Uttara Kanara and Dakshina Kanara are cultivated with rice and sugarcane. Coffee and Tea are also grown on the slopes of the Western Ghats in the district of Kodagu Chikmagalur and Hassan. Karnataka produces 70% of India's coffee, of which about 50% is exported. The black soil in the northwest of the state, is hospitable for the growth of cotton, onion, course cereal, sunflower and peanuts. The forests of the Malnad region produce timber, bamboo and sandalwood. Karnataka is the only exporter of sandalwood in the country. Most of the world's sandalwood oil is produced in Karnataka. All of India's gold comes from the Kolar district of Karnataka. Karnataka is also rich in minerals which form the bulk of the raw materials for iron and steel industries in the state such as the one at Bhadravati. All of India's Iron ore comes from the Malnad region. The first power station in Asia was set up in Karnataka at Shivasamudra in 1902 to produce

hydroelectric power. Karnataka has 18 power stations which generate annually 16,513 million units. The state, however generates insufficient power and is forced to buy electricity from neighbouring states. Bangalore, the capital of Karnataka, is home to several public sector undertaking aircraft companies, such as Hindustan Aeronautics Limited (HAL), HMT Hindustan Machine Tools, Bharat Heavy Electronics Limited (BHEL), National Aeronautics Limited and also Indian Space Research Organization (ISRO). Bangalore, often referred to as the Silicon Valley of India has the largest number of international and local Information Technology and business process outsourcing (BPO) companies in the country. A number of "IT Parks" have been set up by the Karnataka State Electronics Development Corporation Limited (KEONICS) including Bangalore's "Electronics City" and IT parks in Mysore, Mangalore and Hubli. Bangalore is also home to prestigious higher institutes of learning such as the Indian Institute of Science (IISc) and the Indian Institute of Management (IIM Bangalore). One of the largest SEZ's in India, the ONGC SEZ is coming up at Mangalore, which is currently the fastest growing non metro in the south. The total investment in the ONGC SEZ is expected to cross 100,000 crores. At least three IT SEZ'S are coming up in Mangalore with companies like TCS, Wipro, Lotus and others investing more than 3000 crores and creating 67,000 jobs in Mangalore over the next three years. Mangalore is also attracting investment in the Hospitality sectors with companies like the Maurya and Leela Group investing in the region.
Karnataka is one of the economically more progressive states in India with a GSDP (Gross State Domestic Product) that grew at 9.2% in the year 2006-2007.[13] The total GSDP of Karnataka in 2006-2007 is about Rs. 1940.09 billion ($ 46.19 billion). With an overall GDP growth of 56.2% and a per capita GDP growth of 43.9% in the last decade, Karnataka surpassed all other states in India in terms of economic growth and pushed Karnataka’s per capita income in Indian Rupee terms to sixth place. Till September 2006, Karnataka had received a Foreign Direct Investment of Rs. 78.097 billion ($ 1.7255 billion) for fiscal year 2006-07 placing it in the third spot among states in India. At the end of 2004 unemployment rate of Karnataka was 4.94% compared to national rate of 5.99%. For the fiscal year 2006-07 inflation rate of Karnataka was 4.4% which was less than the national average.

Like much of the rest of the country, the economy is primarily agrarian and employs nearly 56% of the labour workforce. A total of 12.31 million hectares of land is cultivated in Karnataka constituting 64.6% of the total geographical area of the state. Much of this is dependent on the southwest monsoon as only 26.5% of the sown area is under irrigation. Karnataka is also one of the more industrialised states in the country having major industries related to mining, cement, iron and steel, paper, sugar and silk.

Starting from the 1980s, Karnataka has emerged as the information technology capital of the country. A total of 1973 companies in Karnataka are involved in
Information Technology related business including big firms like Infosys and Wipro who have their headquarters in Bangalore. IT exports from Karnataka amounting to excess of Rupees 50,000 crores ($12.5 billion) in the year 2006-2007 accounted for nearly 38% of the entire IT exports from India. This achievement has earned Karnataka's capital city, Bangalore the sobriquet of Silicon Valley of India. Karnataka has also been at the forefront of the rapid strides that India has been making in biotechnology, a relatively new and fledgling industry in India. Karnataka has India's largest bio cluster having 158 of the total 320 biotechnological companies in India. The state also accounts for 75% of India's floriculture, an up and coming industry which supplies flowers and ornamental plants worldwide.

Demography, Government and Administration

The Government of Karnataka is a democratically elected body with the Governor as the constitutional head. The Governor who is appointed for a period of five years appoints the Chief Minister and his council of ministers. Even though the governor remains the ceremonial head of the state, the day to day functions of the government is headed by the Chief Minister and his council of ministers in whom a great deal of legislative powers is vested. Karnataka State has been divided into four Revenue divisions, 49 sub-divisions, 27 districts, 175 taluks and 745 Hobilies / Revenue Circles for administrative purposes.
The State legislature consists of the Legislative Assembly and the Legislative Council. The Legislative Assembly consists of 224 members with one member nominated by the Governor to represent the Anglo-Indian community. The term of the office of the Legislative Assembly is five years. The Legislative Council consists of 75 members among whom 25 are elected by the Legislative Assembly members, 25 are elected by local authorities, 7 are elected by graduates, 7 by the teachers and 11 members are nominated by the Governor of Karnataka. The Legislative Council is a permanent body with one-third of its members retiring every two years.

The Executive arm of the Government is headed by Deputy commissioners or District magistrates in each of the 27 districts. These officers belong to the Indian Administrative Service. The district magistrate or the deputy commissioner is assisted by a number of officers belonging to Karnataka Civil Service and other Karnataka state services. A Deputy Commissioner of Police, an officer belonging to the Indian Police Service is entrusted with the responsibility of maintaining law and order and related issues of the district. He is assisted by the officers of the Karnataka Police Service and other Karnataka Police officials. Apart from them, a Deputy Conservator of Forests, an officer belonging to the Indian Forest Service also serves the government. Sectoral development is looked after by the district head of each development department such as PWD, Health, Education, Agriculture, Animal husbandry, etc. These officers belong to the various State Services. The judiciary is headquartered in Bangalore where the Attara Kacheri
houses the High court of Karnataka. There are courts in every district centres and some taluk centres. Justice Cyriac Joseph is the current Chief Justice of the Karnataka High court.

The politics of Karnataka is dominated by three major parties, Indian National Congress, Janata Dal (Secular) and Bharatiya Janata Party. The current Government is a coalition government formed by the Janata Dal (Secular) and Bharatiya Janata Party. The Chief Minister is H. D. Kumaraswamy of Janata Dal (Secular) and the Deputy Chief Minister is B. S. Yediyurappa of Bharatiya Janata Party. The citizens of Karnataka also elect 28 members to the Lok Sabha, the lower house of the Indian Parliament. Several politicians and bureaucrats from Karnataka have served in the Indian Government at various times in different capacities. Deve Gowda, who hails from Hassan district served as the prime minister. B D Jatti from Bijapur served as the Vice President and also as acting President in the past.

According to the 2001 census of India, the total population of Karnataka is 52,850,562. Of this, 26,898,918 (50.89%) are male and 25,951,644 (49.11%) are female. There is a decadal increase in population of 17.25% from 1991 to 2001. Population density is 275.6 per km², the sex ratio is 964 females to 1000 males and 33.98% of the people in Karnataka live in urban areas. The literacy rate is 66.6% with 76% of males and 57% of females being literate.[5] 83.8% of the
population are Hindu, 12.23% are Muslim, 1.91% are Christian, 0.78% are Jains, 0.73% are Buddhist and remaining belong to other religions.

Kannada is the official language of Karnataka and is spoken as a native language by about 64.75% of the people. Other linguistic minorities in the state as of 1991 are Urdu (9.72%), Telugu (8.34%), Marathi (3.95%), Tamil (3.82%), Malayalam (1.69%), Tulu (3.38%), Konkani (1.78%) and Hindi (1.87%). As per the 2001 census, the six largest cities of Karnataka in order of their population are Bangalore, Hubli-Dharwad, Mysore, Gulbarga, Belgaum and Mangalore. Bangalore is the only city with a population of more than 1 million. Bangalore Urban, Belgaum and Gulbarga are the most populous districts, each of them having a population of more than three million. Gadag, Chamarajanagar and Kodagu districts have a population of less than a million.

Transportation in Karnataka

Air transport in Karnataka, much like the rest of the country is still a fledgling but fast expanding sector. Karnataka has airports at Bangalore, Mangalore, Hubli, Belgaum, Hampi and Bellary. Airports at Mysore, Gulbarga, Bijapur, Hassan and Shimoga are expected to be operational by the end of 2007.[16] However, international flights operate only from Mangalore and Bangalore airports. While the international flights from Mangalore are limited to countries located in the Middle East, Bangalore has good international connectivity to several hubs. A
new airport being constructed at Devanahalli in the outskirts of Bangalore is expected to be operational by April 2008. Bangalore is the headquarters of Kingfisher Airlines and also of the low-cost airline Air Deccan which has been instrumental in opening up the previously unused airports of Hampi, Bellary, Hubli and Belgaum to passenger air traffic.

Karnataka has a railway network having a total length of approximately 3,089 kilometres (1,919 mi). For a long time after independence, the railway network in the state was under the Southern and Western railway zones which were headquartered at Chennai and Mumbai respectively. The South Western Zone, headquartered at Hubli was created in 2003 thus fulfilling a long standing demand of the state. Several parts of the state now come under this zone with the remaining being under Southern Railways. Coastal Karnataka is covered under the Konkan railway network, a project that is regarded as one of the feats of Indian engineering and included the construction of a bridge of length 2,023 metres (6,637 ft). across the river Sharavathi at Honnavar and a tunnel of length 2,960 metres (9,711 ft) at Karwar. Bangalore, the capital city, is extensively connected with inter-state destinations while other important cities and towns in the state are not so well-connected.

Karnataka has one major port; the New Mangalore Port and ten minor ports; Karwar, Belekeri, Tadri, Honnavar, Bhatkal, Kundapur, Hangarkatta, Malpe, Padubidri and Old Mangalore.[19] The construction of the New Mangalore Port
was commenced in 1962 and completed in 1974. It was incorporated as the 9th major port in India on 4th May 1974. This port handled 32.04 million tonnes of traffic in the fiscal year 2006-07 with 17.92 million tonnes of imports and 14.12 million tonnes of exports. The port also handled 1015 vessels including 18 cruise vessels during the year 2006-07. The Inland water transport within the state is not well developed.

The total length of National Highways and state highways in Karnataka are 3,973 kilometres (2,469 mi) and 9,829 kilometres (6,107 mi) respectively. KSRTC, the state public transport corporation owns 5400 vehicles, operates 5100 schedules covering 1,950,000 kilometres (1,211,674 mi), transports an average of 2.2 million passengers daily and employs about 25,000 people. In the late nineties, KSRTC was bifurcated into three corporations viz., Bangalore Metropolitan Transport Corporation, North-west Karnataka Road Transport Corporation and North-East Karnataka Road Transport Corporation. These corporations are headquartered at Bangalore, Hubli and Gulbarga respectively.

Education in Karnataka

As per the 2001 census, Karnataka has a literacy rate of 67.04% with 76.29% of males and 57.45% of females in Karnataka being literate. Karnataka is home to some of the premier educational and research institutions of India like the Indian
Institute of Science, Indian Institute of Management and the National Law School of India University.

As of March 2006, Karnataka has 54529 primary schools with 252,875 teachers and 8.495 million students. There are 9498 secondary schools with 92287 teachers with 1.384 million students. There are three kinds of schools in Karnataka viz. government (run by the government), aided (financial aid is provided by the government) and un-aided private (no financial aid is provided). The language of instruction in most schools is English or Kannada. The syllabus taught in the schools is either of CBSE, ICSE or the state syllabus (defined by the Department of Public Instruction of the Government of Karnataka). In order to maximize attendance in schools, the Karnataka Government has launched a mid-day meal scheme in government and aided schools in which free lunch is provided to the students.[38] State wide board examinations are conducted at the end of secondary education and students who qualify are allowed to pursue a Pre university course after two years of which, students become eligible to pursue under-graduate degrees.

There are 481 degree colleges affiliated to one of the universities in the state viz. Bangalore University, Mysore University, Mangalore University, Gulbarga University, Kuvempu University and Karnatak University. In 1998, the engineering colleges in the state were brought under the newly formed Visvesvaraya Technological University headquartered at Belgaum whereas the
medical colleges are run under the jurisdiction of the Rajiv Gandhi University of Health Sciences. Some of these baccalaureate colleges are accredited with the status of a deemed university. There are 123 engineering, 35 medical and 40 dental colleges in the state.

Among the service oriented sectors, Karnataka leads the Indian biotechnology industry. IT/ITeS is another thriving industry in the State, concentrated in and around Bangalore, the silicon valley of India. The State prides having a strong infrastructure. There are 20 ports across Karnataka, the two major ones being the Mangalore port and the Karwar port. A number of national and State highways make inter-city and town communication easily accessible. Karnataka also has a strong railway and airport network. Karnataka is a preferred destination for investments. The Karnataka Udyog Mitra is a single contact point for all investors who wish to invest in the State.

1.7 Medium-Term Fiscal Plan for Karnataka, 2000–2001 to 2004-05

State governments in the country, like their Central counterpart, have started to recognise the significance of industrial infrastructure and social infrastructure for their economic growth. In the process, they have admitted the need to promptly release resources for the improvement of infrastructure. They expect the private sector to contribute their mite to the development of their economies. This warrants that the State governments create the right environment for
accommodating the private sector. This has also led to a healthy competition emerging amongst the States.

Although the fiscal situation in Karnataka has not yet reached the crisis point, the said point is not far away. Unless certain corrective measures are launched on a war footing, it may become difficult to put the finances of the State back on the rails. To facilitate a discussion on the fiscal health of the State, the government of Karnataka placed a White Paper on its finances in the budget session of the Assembly in March 2000. The White Paper identified the sources and causes of stagnancy in revenues and the reasons for the proliferation of public expenditure and came up with suggestions to initiate corrective measures. This is apart from its insistence that the reforms be carefully calibrated to achieve the required fiscal correction. It recognised that fiscal deterioration in the State had accumulated over several years. The White Paper therefore felt that a road map should be drawn up carefully in the medium term for the purpose. The medium-term framework allows designing implementable reforms and applying remedies depending on changing situations and imperatives. The White Paper emphasised the need to have an explicit medium-term fiscal framework for the State government. In other words, the Medium Term Fiscal Plan or MTFP should convey the government's commitment to greater fiscal transparency.

The following are some of the paragraphs of the MTFP verbatim:
1. Introduction:

1. Economic reforms, under way since 1991, have posed important challenges as well as opportunities to the state governments. Accelerating economic growth and reducing poverty call for releasing resources for strengthening infrastructure facilities in the states and making substantial allocation of resources to rural development, health and education. State governments have a predominant role in the task of strengthening physical infrastructure and, more particularly, in human development. Besides, the greater role assigned to the private sector has confronted the states with the challenge of creating an accommodating environment in the wake of fierce inter-state competition. Karnataka has to participate in this competitive environment. This calls for the creation of a climate for realising the growth potential by attracting private investment. However, to be a favourable destination for private investment the State government should not only follow investment-friendly policies but also create high quality infrastructure and finance it through an efficient tax system. The challenge is particularly severe because the fiscal condition of the State has been deteriorating sharply. Although the fiscal situation in Karnataka, unlike in many other states, has not yet reached the crisis point, it will not be long before it becomes unsustainable if the present trend continues.

2. The State government is seized of the problem and is keen to undertake immediate corrective measures to put its finances back on the rails. To promote wider discussion on the fiscal health, the State government placed a White Paper
3. The fiscal deterioration in the State is not the result of fiscal operations in one or two years but has accumulated over several years. Given the magnitude of the problem, fiscal correction cannot be achieved within one or two years. Besides, fiscal decisions of one year are not confined to that year, but have multiyear consequences. Thus, a road map for corrective measures will have to be drawn up carefully in the medium term. The medium-term framework allows designing implementable reforms, and applying remedies depending on changing situations and imperatives. Therefore, the White Paper has emphasised the need to have an explicit medium-term fiscal framework for the State government.

4. The preparation of Medium Term Fiscal Plan (MTFP) is part of the State government's commitment to greater fiscal transparency. Other important steps already taken in this direction include publication of an "Overview of the Budget" which provides basic fiscal data and information on guarantees. To further improve transparency, the Govt has included in this publication information on off-budget borrowings, tax arrears and tax expenditure (cost of tax incentives)
from the current year. The Govt has also started publishing monthly financial accounts on the internet (http://kar.nic.in/statebudget).

5. The medium-term framework should set fiscal targets and detail the policy package necessary to achieve them. These targets and policies will have to be dovetailed to the annual budgetary exercises to operationalise the restructuring plan. The budgetary exercise also provides an opportunity to the State government to update the medium-term fiscal framework every year. This framework sets the targets for all the years up to 2004–2005 and details the important policy measures to achieve these targets.

6. It must be mentioned at the outset that bringing about fiscal rectitude entails hard decisions. This has to be a rational community choice to achieve the common good on a sustainable basis. Difficult but unavoidable measures will have to be taken to raise revenues, to weed out unproductive expenditures and to stabilise debt. Postponing these measures will only compound the problems, necessitating much harsher remedial measures in the future. After carefully considering the available options, the State government has decided to embark on the medium-term plan to achieve fiscal balance by reforming policies, processes and institutions.
II. The Problem:

7. The White Paper on the State's finances has brought out significant deterioration in the fiscal position in Kamataka over the last decade particularly since 1995-96. The fiscal position was transformed from a revenue surplus of Rs.159 crores in 1995-96 (accounts) to a revenue deficit of Rs.2325 crores in 1999-2000 (accounts). Similarly, during the period from 1990-91 to 1999-2000, the fiscal deficit increased from Rs. 513 crores to Rs.4276 crores. This has created an unstable fiscal situation characterised by a vicious cycle of increasing interest payments feeding into deficits and debt stock. The continuation of the prevailing trend will surely land Karnataka in a crisis within the next few years.

8. An important cause of deteriorating fiscal situation in the State is declining share of revenues to Gross State Domestic Product (GSDP). The ratio of tax revenue to GSDP has fallen from 9.3% in 1990-91 to 8.2% in 1999-2000. The ratio of non-tax revenue to GSDP has shown a decline from 2.2% in 1990–91 to 1.17% in 1999–2000, mainly due to low and declining cost recoveries from non-merit public services and poor performance of the public enterprises. Implicit subsidies due to uneconomic pricing of irrigation and drinking water supply, higher and technical education and urban health services amount to about 1.2 per cent of GSDP. Cost recovery in irrigation in the State is only a fraction of the corresponding figures prevailing in the neighbouring states.
9. An equally worrisome issue of the State finances in Karnataka is the dismal financial performance of public utilities and enterprises. In 1998-99, the State government paid Rs. 914 crores to Karnataka Electricity Board by way of explicit subsidy alone. The losses from Karnataka State Road Transport Corporation in 1997-98 amounted to Rs. 54.6 crores (after payment of a State Govt subsidy of Rs. 41.2 crores). Besides these, there are a number of public enterprises, many of which are of commercial nature, which have been making significant losses. Out of 78 government companies, 33 made losses in 1997-98 amounting to Rs. 197 crores. In case of 22 companies, the accumulated loss exceeds the share capital, reserves and surpluses put together.

10. Another important reason for the fiscal problem is the fast expansion of public expenditures within the revenue account during the last few years. The significant increase in salary and pensions, interest payments, subsidies and transfers has pre-empted a high and increasing proportion of borrowed funds for meeting current expenditures. Interest payments as a proportion to GSDP increased from 1 per cent in 1989-90 to about 2.12% per cent in 1999-2000. During this period, the subsidies and transfers as a ratio of GSDP also increased by about one percentage point.

11. The problem is accentuated by the declining productivity of public expenditure, which in turn has come about due to a sharp increase in administrative expenditures, poor maintenance of public assets, declining
portion of capital expenditures and long gestation periods in completing infrastructure projects. Moreover, increase in indebtedness has resulted in higher and higher amount being set apart for debt servicing, leaving a relatively less amount for productive expenditure.

III. Objectives and Targets:

12. The medium-term fiscal restructuring plan will have to reverse the historical trend of the deteriorating fiscal situation in order to phase out public dis-savings in the medium term so that borrowed funds are invested to create productive assets and shore up the fiscal situation. The strategy in the medium term should also enhance productivity in public spending to ensure efficient and equitable delivery of public services. Finally, increasing requirements of public expenditure should be financed through an efficient and equitable tax system and proper cost recovery. Thus, the medium-term fiscal plan, while ensuring satisfactory levels of infrastructure should also pave the way for increased private sector investments, which will result in accelerating economic growth and reducing poverty in the State.

13. The State government places emphasis on substantially achieving the above objective in the medium term. With this in view, its main target under the medium-term fiscal plan for 2004-05 is as follows:
(i) Phasing out revenue deficits by 2004-05 from 1.49 per cent of GSDP in 2000-01 (BE), so that borrowing is not used to finance current expenditures.

(ii) Reducing fiscal deficit from the present level of 3.66 per cent of GSDP (2000-01 BE) to 3 per cent of GSDP during the same period to stabilise debt stock, and prevent an ever-increasing burden of interest payments.

(iii) Safeguarding adequate allocation to social sectors like basic health care and primary and secondary education and for physical infrastructure requirements, both for investment and for maintenance.

14. These objectives will have to be achieved by initiating a concerted programme of tax reform, reform in the structure and management of expenditures, levying appropriate user charges, public enterprise reform and reform in administration and governance. Specifically, achieving the above objectives will require:

1. Improving the revenue productivity of the taxes by bringing about systemic changes in the base, rate structure and administration and enforcement mechanisms. The introduction of value added tax (VAT) would be one of the major reform initiatives that is expected not only to rationalise the consumption tax system, but also to improve revenue productivity;
enhancing productivity of non-tax revenue. In case of user charges, this is to be brought about by greater community participation in maintenance of assets and by ensuring quality and reliability of services. Public enterprises reforms would unleash productivity gains for generating better receipts;

reducing budgetary support to public enterprises. This has to be achieved by disinvesting and restructuring public enterprises. While in some cases it may be necessary to introduce voluntary retirement schemes (VRS) to reduce over-employment, government may have to close down or privatise some of the enterprises;

drastic reduction of implicit and explicit subsidies to electricity and transport sectors through economic pricing, improving productivity in generation, transmission and distribution and metering the consumption of electricity by the agricultural sector and privatisation of distribution;

achieving significant improvement in cost recoveries and reducing implicit subsidies in respect of services, such as drinking water supply, irrigation, higher and technical education, and secondary and tertiary health care, particularly those not directed to the poor;

reducing the quantum of food subsidies by eventually targeting it strictly to persons below the poverty line;
improving the efficiency of government expenditures by increasing allocation to the creation and maintenance of infrastructure facilities and augmenting outlay on human development;

compressing unproductive government expenditures by reducing government employment and re-deployment to social sectors such as primary and secondary education and health;

assessing expenditures in irrigation and public works departments by closely scrutinising the schedule of unit rates. Sequencing expenditures on major projects to minimise time and cost overruns and improving public expenditure management and control systems by increasing the level of public participation (e.g. through creating water user associations) and investment;

ensuring a careful debt management plan to reduce the composition of high cost borrowing and to limit contingent liabilities. In particular, a close scrutiny of contingent liabilities, moving away from borrowing at high cost from small savings loans and from specialised financial institutions like HUDCO, LIC and NCDC; borrowing on the basis of repayment capacity rather than availability as in the past;

improving governance, putting in place a sound public expenditure management programme to improve the efficiency of expenditure and targeting.
15. The State government has already initiated a number of reform measures in many of the above areas. These include establishment of the Tax Reforms Commission, Administrative Reforms Commission and Public Sector Restructuring Commission, initiating measures to restructure and privatise the power sector, adoption of a new policy for restructuring of public sector undertakings, increases in user charges for various services, hiring restraint and abolition of positions, and initiating action towards introduction of Value Added Tax. Revised estimates for 2000-01 already show a substantial improvement in fiscal performance, for example a reduction in the fiscal deficit from 4.5% of GSDP in 1999-2000 to 4.03% and a reduction in the revenue deficit from 2.45% of GSDP in 1999-2000 to 2.11%.

16. Since it is the responsibility of the State government to repay the loans contracted by two specialised irrigation finance corporations, i.e., KBJNL and KNNL, a set of “consolidated” fiscal indicators have been worked out by adding the off-budget borrowings and repayments to the traditional budgetary figures. The “consolidated” figures also capture the borrowings by State undertakings, e.g., from HUDCO or through raising of bonds, where the liability for repayment is on the State government. These are actual repayment liabilities of the government and not in the nature of contingent liabilities. MTFP assumes that such exceptional borrowings by KBJNL and KNNL to complete the Krishna river projects will cease by 2004-05. It is also the intention of the State government to reduce off budget borrowings and to move all such borrowings back on to the
budget by end-2004-05. No additional recourse to off-budget borrowing will be made beyond the current beneficiaries. At present, these "consolidated" figures have greater relevance in the assessment of the true fiscal situation of the State. An important objective of the MTFP is to stabilise consolidated debt as a ratio of GSDP, besides reducing consolidated fiscal deficit to 3% of GSDP.

17. One important method of limiting debt service payments is to adopt a borrowing strategy to move away from short-term/high-cost loans to long term/low-cost borrowings. Admittedly, small savings loans are one of the high cost sources of borrowing and the State government, in order to ease its hard budget constraint, has been encouraging borrowing from this source. This has been one of the factors in the fast escalation of debt service payments. As a part of debt management strategy, the government will substitute these high-cost loans with low-cost/long-term borrowings from agencies such as the World Bank, ADB and bilateral donor countries. Setting these targets and deciding on an appropriate mix of borrowings would also help in stabilising public debt.

18. The fiscal restructuring plan should cover all contingent liabilities including guarantees issues by the government. The State government has already passed the Ceiling on government Guarantees Act, has introduced guarantee fee, will make budgetary provisions to meet the eventuality of possible discharge of contingent liabilities, and is presently working on the rules for sectoral allocation of guarantees every year.
19. The next stage in working out the medium-term fiscal plan is to project the fiscal scenario during the period on the basis of a reasonable growth of revenues and expenditures. The target growth rates chosen for projections should take into account the degree of fiscal correction required. These targets should be realistic and achievable. For Karnataka, all the targets are expressed as percentages of GSDP in the State. In order to obtain the target in absolute values, GSDP is projected by assuming 7.5 per cent growth per year in real terms. This is in keeping with the recent growth performance in the State, which has averaged 7.4 per cent during the 5 years ending 1998-99. The inflation rate is assumed to be 6 per cent.

20. As already mentioned, the basic reason for the fiscal imbalance in the State is that the growth rate of revenue receipts was significantly lower than that of revenue expenditures. During the last decade, the average annual growth rate of revenue receipts in Karnataka was 14.9 per cent whereas revenue expenditures grew at 15.9 per cent per annum. The actual plan of phasing out fiscal imbalance in the State will have to combine the strategies of increasing the growth of revenues and compressing expenditures, keeping in view the efficiency in raising revenues and productivity of public expenditures.

21. In the medium-term fiscal plan worked out for Karnataka, a combination of the strategies to accelerate the growth of revenues and decelerating expenditures has been adopted. Taking the baseline fiscal situation as in 2000-
2001, the expenditure and revenue projections are simulated to arrive at an implementable plan of achieving the targets. The policy package necessary to achieve the targets for accelerating the growth of revenues as well as decelerating the growth of expenditures has been worked out. The policy imperatives for restoring fiscal balance in Karnataka are discussed in the following sections.

IV. Revenue Projections and Reforms:

22. Improvement in the fiscal situation in the State cannot be achieved unless concerted action is taken to reform the tax system. A comprehensive package of tax reforms will be undertaken after receiving the final recommendations of the Tax Reforms Commission, which are due in September, 2001. The Commission's report is expected to provide a blueprint for reforms not only to minimise distortions, but also to enhance the revenue productivity of the tax system. The first report of the Commission submitted to the government in February, 2001 has highlighted the fall in growth rate of the tax revenue from 1980's to 1990's and also the fall in the ratio of tax revenue to GSDP. At the same time, the Commission is of the opinion that tax rates are generally adequate. The crucial issues that need to be addressed are tax base, i.e., coverage and exemptions, tax slabs, tax compliance and tax administration. The Commission has recommended introduction of Value Added Tax and provided a road map for the same. It has also given concrete recommendations to improve revenue productivity in case of Excise, Motor Vehicles Tax, stamp duties and
registration fees and profession tax. Some of the recommendations have already been incorporated into the budget of 2001-02. The State government will prepare an implementation programme based on the Commission's recommendations to improve the tax buoyancy.

23. In the mean time a number of steps have already been taken to improve the buoyancy of commercial taxes. The recent imposition of floor rates in all the States and Union Territories is likely to minimise revenue loss due to trade diversion. The abolition of tax incentives for industries too will improve the revenues and reduce distortions. A decision has been taken to bring about a phased introduction of Value Added Tax (VAT) in 2002. The introduction of VAT, though predicated to be revenue neutral, may result in a small decline in the revenue in the short run. The government will have to improve the administration and enforcement of the taxes to make sure that this decline is confined to only the initial period of 2 years.

24. The reform measures already initiated and those that will be taken up are expected to improve revenue productivity of the tax system. Implementation of tax reforms in the coming years and better administration and enforcement of the taxes are expected to improve revenue productivity at least to the extent assumed in this exercise, and will also result in an improved tax-GSDP ratio (from 8.15% in 1999-2000 to 9.42% in 2004-05). Tax-GSDP ratio has already improved from 8.15% in 1999-2000 to 8.95% in 2000-01 (RE).
In regard to non-tax revenues, the government's objective is to ensure full recovery of operating costs for economic services. However, it will take time to achieve this goal, and will be attempted in a progressive manner. In order to inculcate ownership of assets and services, some contribution to capital costs from beneficiaries, either at the initial stage of the project, or later during the operation of the services, will also be an objective. Appropriate policy measures will have to be taken to increase user charges from higher and technical education, health, irrigation and drinking water supply. This will be easier to achieve if simultaneous steps are taken to enhance the quality of service provided to the users. Higher cost recoveries in respect of these services are necessary not merely to improve the fiscal situation but also to reflect their economic values with appropriate adjustment made for social obligations. Thus, in the case of the health sector, proper pricing of secondary and tertiary health care services and various clinical and other medical tests conducted in the hospitals and dispensaries should help in achieving higher cost recovery. Similarly, cost recovery in secondary education is estimated to increase from 0.95% (2000-01 RE) to 2.13%, in higher education from 0.3% to 2.2%, in technical education from 3.2% to 22.5%, in major and medium irrigation from 33% to 82%, in minor irrigation from 5.26% to 20%, and in rural drinking water supply from 0.61% to 2%. Other non-tax revenues are assumed to grow at their historical rates. The State government has already revised the irrigation water rates during 2000-01 to about 2.5 times of the earlier rate. In case of rural water supply and health, the improved recovery will be used at the field level to meet
part of the O&M expenditure and will not come back to the government. This envisages progressively greater participation of the community in maintaining the

26. Another area where concerted effort is needed is effecting recoveries from the beneficiaries of housing provided by the government. While the expenditure on housing has increased substantially over the years, cost recovery from beneficiaries is negligible. Only when loans are recovered from beneficiaries will it be possible for the government to repay the loan to the Housing Finance Agencies and obtain more loans for new beneficiaries. It is therefore proposed that on housing loans, the recovery will be stepped up from 18% in 2001-02 to 31% in 2004-05.

27. Karnataka state has been a pioneer in democratic decentralisation. Rural and Urban Local Bodies receive funds from the State government as per the recommendations of the State Finance Commission. However, these bodies do experience fiscal stress. Government will explore possibilities of augmentation of revenue of these local bodies. A system of self-assessment of property tax has shown considerable promise in Bangalore city. This will be gradually extended to other cities.

28. Revenue from central transfers accruing to the State depends on the recommendations of the Finance Commission, policies of the Planning
Commission and programmes of the central ministries implemented through the States. The Eleventh Finance Commission has already made its recommendations regarding tax devolution, non-plan grants, and calamity relief. The State's entitlement for the five years has been worked out on the basis of these estimates. The second report of the Finance Commission deals with an incentive-linked additional transfer based on the fiscal reforms undertaken by the States. Since the present MTFP is fully consistent with such fiscal reforms, the allocation made for Karnataka on this account has been assumed in the MTFP.

29. The State government recognises the importance of an accurate model for arriving at revenue projections for each year during the budgetary exercise. To improve revenue and expenditure forecasting, a study on fiscal marksmanship has been commissioned. Its results will be used from the budgetary cycle of 2002-03.

V. Expenditure Reforms

30. Restoring fiscal health in Karnataka critically depends upon compressing expenditures and prioritising them to enhance efficiency in public spending. In order to achieve this, prioritisation of expenditure is essential. It is also necessary to provide adequately for maintenance of existing assets. Continuously increasing the plan expenditures on the assumption that they are necessarily productive will only result in negligence of maintenance, which reduces technical efficiency in spending, as has been the case in the past. The expenditure policy,
thus, will have to be calibrated to conform closely to the fiscal targets, commitments and priorities.

31. One of the most important components of expenditure expansion in recent years has been wages and salaries. The government has already announced its intention of abolishing 80 per cent of the vacant posts as per the Finance Minister's budget speech of 2000–01. This implies that almost 10 per cent of the posts of the State government would have to be reduced. However, while drawing up the medium term fiscal plan, liberal exemptions have been allowed in case of primary and secondary education, health, police, forest and wildlife protection.

32. Another measure in the downsizing agenda is to leave posts vacant when the incumbents retire. The State government intends to abolish one-third of the retiring posts (other than primary and secondary education, health, police, forest and wildlife protection) in each of the ensuing four years. This would require detailed department-wise personnel planning, which will be undertaken as soon as possible. The two measures taken together will reduce the number of government posts by more than 12 per cent by 2004–05. Similarly, measures have already been initiated to reduce grants-in-aid to private higher educational institutions.
33. Unfortunately, there is not much flexibility in regard to expenditure on pensions and interest payments. Nevertheless, in the case of the latter, attempts will be made to reduce the composition of loans bearing high interest rates. Since a regime of falling interest rate prevails now, efforts are on to retire high cost debts of KBJNL by using fresh low-cost borrowings. Government will improve its pension forecasting capability through, inter alia, establishment of a human

34. As already mentioned, it is necessary to improve the productivity of public spending even while reducing expenditures. A major target of the medium term plan is to ensure adequate investments in creation and maintenance of physical infrastructure. This is necessary to ensure a competitive edge to the economy.

Therefore, the medium-term fiscal plan makes adequate allocation to maintenance of roads, buildings and irrigation works. In order to ensure this, the framework has provided for gradually phasing in allocation according to the Eleventh Finance Commission norms. This involves significant stepping up of expenditures in these sectors. From the viewpoint of expenditure efficiency, stepping up expenditures in these sectors is highly desirable.

35. Another important area of fiscal correction is in compressing subsidies. This is an area where significant effort is necessary. As outlined in the White Paper, the State government has already commissioned a detailed study to quantify the
volume and composition of implicit and explicit subsidies and to formulate an appropriate strategy to reduce them in a phased manner, *inter alia*, through

36. The power sector represents a huge drain on the government’s resources and poses the biggest fiscal risk in the near future. It will be impossible to eliminate revenue deficit without comprehensive structural reforms in this sector. Recognising this, the State government has set up a regulatory commission, which has already issued its first tariff order. The electricity board has been corporatised and generation has been separated from transmission and distribution. Key to eliminating power sector subsidy is loss reduction, which will be done through universal metering and privatisation of distribution, and regular tariff increases to achieve full cost recovery. The MTFP assumes progressive decline in T&D losses from 37% in 2000-01 to 28% in 2004-05. The power sector reforms will bring back fiscal sustainability to the sector and make power supply more reliable for the consumers thus spurring economic growth. In the interim period, government is fully committed to meeting its financial obligations to the sector. Consistent with the MTFP, the government has drawn up a Financial Restructuring Plan for the power sector, which gives a road map for elimination of subsidy over the next 10 years.

37. Among explicit subsidies that need to be properly targeted is the food subsidy being given to ration card-holders. At present there are about 65 lakh green
cards meant for families below poverty line. These cards entitle the families to buy food grains at a subsidised rate. The total subsidy stands at Rs.300 crores in 2000-01. The actual number of families below poverty line (BPL) in the State is much lower than this number and is estimated at about 30 lakh. Thus there were 35 lakh EBPL (extra BPL) cards, which could avail of food grain at BPL rate, but for which the State government had to pay to FCI at a much higher APL (above poverty line) rate. Government has issued orders in July 2000 to remove 8 lakh ineligible cards from this category. This will significantly reduce the subsidy burden. Constant efforts will be made to target the subsidy to deserving beneficiaries in future. With this in mind, a new category of yellow cards for only BPL families is being introduced to target the really needy beneficiaries. For others left over under green card scheme, average prices of commodities will be higher requiring a lower subsidy per family. It is assumed that in each of the years from 2001-02 onwards, additional cards would be removed from EBPL category, The government intends to cap the food subsidy in nominal terms to the level prevailing in 2000-01 and would work out a detailed strategy to make this happen.

38. In the case of the transport sector too, significant reduction in subsidies is envisaged by rationalising the pricing policy and improving productivity. The cost recovery from concessional pass holders is targeted to improve from 6% to 15% while permitting cross subsidisation from 74% at present to 82% in 2004-05 thereby reducing the subsidy obligation. The State government has already
39. Government used to give subsidies to encourage establishment of small scale industries. It was not possible to discharge the liabilities from year to year on this account. The liability has been discharged as a one-time measure through raising of bonds by KSFC, where the repayment obligation is on State government. This has been captured in the Medium Term Fiscal Plan. From April 2000, this subsidy is limited to only tiny industries thereby bringing down the annual liability to a large extent.

40. Social welfare expenditure is meant to benefit the scheduled castes, scheduled tribes, backward classes, minorities and other weaker sections of the society. The State government will try to ensure that assistance to these disadvantaged sections will be continued and in some cases expanded to enable them to access the benefits of growth. Thus, strength in social welfare hostels is assumed to increase at the rate of 2 per cent per year. Anganwadi expenditures are projected on the assumption of the number of children increasing at 2 per cent, the unit rate increasing by 20 per cent in 2001-02 and the remaining at that level till 2004-05. Social pensions too are projected to increase by 2 per cent per year and all other items of social welfare expenditure are assumed to grow at the rate of inflation.
41. Given that the State government has predominant responsibility in development of human capital, while compressing expenditure growth, it is necessary to protect allocations to the social sectors like primary and secondary education and health. As already mentioned earlier, 50 per cent of the vacant posts to be filled are assumed to be transferred to education and health sectors. In estimating the salary expenditures of these sectors, this additional employment has been taken account of. This additional provision of posts in these sectors is expected to ensure better spread and improvement in the quality of social services. The non-salary component of expenditure in education and health is assumed to increase significantly. With these projections, there would be adequate allocation for elementary education to achieve 100% enrolment by 2006-07. Specifically, the State government’s target is to ensure that by 2007, all children in the school going age group of 6-14 years are not only enrolled, but are enabled to complete 8 years of schooling. Similarly, the enhanced allocation in health sector would be an important step in ensuring universal access to primary health care, and achieving the State’s health targets.

42. A major target of the medium term fiscal plan is to ensure adequate investment in physical infrastructure, which has a catalytic effect on economic growth. In the Medium Term Fiscal Plan, reduction of revenue expenditure would result in more funds being freed for capital outlay. In turn, better physical infrastructure would attract larger private investment into the State to complement the efforts of the State government. Another important feature would
be completion of most of the irrigation works in Krishna Basin by 2003-04, which would free resources for capital expenditure in other critical sectors. Thus the on budget capital expenditure (actual expenditure on capital formation) will go up to a healthy 2.41% of GSDP, while off-budget capital expenditure will decline. It will also ensure that the size of the annual plan grows at a healthy rate and a greater portion of the plan is used for capital formation rather than on revenue account. More specifically, capital expenditure on drinking water supply, roads and bridges, education and health would receive a very significant boost.

43. The MTFP projections will result in significant increase in high priority development expenditures in a progressive manner throughout the five-year period. These expenditures can basically be classified into two types: (i) expenditure on social sectors and human capital formation, and (ii) expenditure on creation and maintenance of physical infrastructure.

44. An important component of expenditure reform is establishment of a system of accountability and incentives in expenditure implementation. This calls for a thorough overhaul of the public expenditure management system. Fixation of responsibilities to individual agents and ensuring the establishment of a system to ensure effective implementation are necessary to impart efficiency in public spending. The system should ensure that the expenditures are indeed incurred for the intended purpose in a productive manner to ensure creation of value for money spent. The system should create enough disincentives for rent seeking
behaviour. As a first step, the government has already constituted an Expenditure Review Committee with a mandate to scrutinise all new expenditure proposals and underlying policies, particularly with reference to their medium term implications. The policy paper on governance will consider the issue of public expenditure management in greater detail.

45. The policy changes envisaged when translated in terms of projection of revenues and expenditures show phasing out of the revenue deficit in Karnataka as a part of the set target. In fact, the projections are estimated to improve the revenue deficit from 1.49% (2000-01 BE) to a revenue surplus of 0.42% in 2004-05, and the consolidated revenue deficit of 2.01% of GSDP (2000-01 BE) to 0.17% in 2004-05. Similarly, as per the target, the on-budget capital expenditures are estimated to increase from the present level of 1.66% of GSDP (2000-01 BE) to 2.41% in 2004-05. Consolidated fiscal deficit during the same period would decrease from 5.44% of GSDP to 2.76%. The consolidated debt stock, after showing an initial increase from the current level of 30.61% (2000-01 BE) to 32.65% in 2001-02, will decline to 31.03% in 2004-05 and will continue to fall thereafter. The main fiscal indicators in terms of rupees and as percentage of GSDP are given in Tables 1 and 2 respectively.
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<td>Transport, &amp; Industry)</td>
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<td>468</td>
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<td>545</td>
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Source: [http://kar.nic.in/statebudget](http://kar.nic.in/statebudget)
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<th>Year 6</th>
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<th>Year 8</th>
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<td>1707</td>
<td>1612</td>
<td>1947</td>
<td>2267</td>
<td>2837</td>
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<td>4148</td>
<td>5127</td>
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<td>7. Total Debt Stock</td>
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<td>9. Salary+Pension+Interest</td>
<td>8127</td>
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<td>8751</td>
<td>9950</td>
<td>11002</td>
<td>12104</td>
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<td>10. Consolidated Revenue Deficit</td>
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<td>2072</td>
<td>2525</td>
<td>3296</td>
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<td>11. Consolidated Fiscal Deficit</td>
<td>5288</td>
<td>5601</td>
<td>6017</td>
<td>6926</td>
<td>6855</td>
<td>5841</td>
<td>4818</td>
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<td>12. Consolidated Capital expenditure</td>
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<td>3832</td>
<td>3738</td>
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<td>13. Consolidated interest</td>
<td>2407</td>
<td>2928</td>
<td>2766</td>
<td>3564</td>
<td>4218</td>
<td>4918</td>
<td>5510</td>
<td></td>
</tr>
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</table>
14. Consolidated Debt Stock | 28406 | 31525 | 31525 | 38497 | 43474 | 49315 | 54132
15 Off-budget borrowings | 1011 | 1987 | 1987 | 1885 | 1450 | 930 | 514
16 Interest/Revenue | 16.21% | 15.86% | 16.75% | 16.44% | 16.43% | 17.09% | 17.15%
17 Consolidated Interest/Revenue | 19.40% | 19.40% | 19.17% | 20.57% | 21.43% | 21.85% | 21.11%
18 Debt Service/Revenue | 20.17% | 19.25% | 20.33% | 20.52% | 20.63% | 21.89% | 22.05%
19 Salary+Pension+Interest)/Revenue | 65.49% | 59.49% | 60.65% | 57.42% | 55.90% | 53.77% | 50.27%

/* Capital expenditure is actual expenditure on capital formation, and excludes debt servicing of off-budget borrowing, which is included in capital expenditure under budgetary definitions. Thus, in this table, the fiscal deficit does not equal the revenue deficit plus capital expenditure plus net loans advanced.*/
Table - 1.2
Karnataka Medium Term Fiscal Plan (as percentage of GSDP)\(^8\)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
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<tr>
<td>GSDP at Current Prices (Rs. crores)</td>
<td>94991</td>
<td>102994</td>
<td>102994</td>
<td>117915</td>
<td>134364</td>
<td>153108</td>
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<tr>
<td>Inflation</td>
<td>7.50%</td>
<td>6.50%</td>
<td>6.50%</td>
<td>6.50%</td>
<td>6.00%</td>
<td>6.00%</td>
</tr>
<tr>
<td>GSDP Annual Real Growth</td>
<td>7.50%</td>
<td>7.50%</td>
<td>7.50%</td>
<td>7.50%</td>
<td>7.50%</td>
<td>7.50%</td>
</tr>
<tr>
<td>1. Revenue Receipts</td>
<td>13.06%</td>
<td>14.65%</td>
<td>14.01%</td>
<td>14.70%</td>
<td>14.65%</td>
<td>14.70%</td>
</tr>
<tr>
<td>1 (a) State' Own Tax Revenues</td>
<td>8.15%</td>
<td>9.13%</td>
<td>8.95%</td>
<td>9.20%</td>
<td>8.98%</td>
<td>9.05%</td>
</tr>
<tr>
<td>1 (b) Non Tax Revenues</td>
<td>1.17%</td>
<td>1.20%</td>
<td>0.83%</td>
<td>1.11%</td>
<td>1.06%</td>
<td>1.01%</td>
</tr>
<tr>
<td>1 (c) Resources from the Centre</td>
<td>3.74%</td>
<td>4.32%</td>
<td>4.24%</td>
<td>4.39%</td>
<td>4.61%</td>
<td>4.64%</td>
</tr>
<tr>
<td>2. Revenue Expenditure</td>
<td>15.51%</td>
<td>16.14%</td>
<td>16.12%</td>
<td>16.92%</td>
<td>16.40%</td>
<td>15.49%</td>
</tr>
<tr>
<td>2 (a) Interest</td>
<td>2.12%</td>
<td>2.32%</td>
<td>2.35%</td>
<td>2.42%</td>
<td>2.41%</td>
<td>2.51%</td>
</tr>
<tr>
<td>2 (b) Salaries</td>
<td>4.82%</td>
<td>4.86%</td>
<td>4.63%</td>
<td>4.49%</td>
<td>4.31%</td>
<td>4.01%</td>
</tr>
<tr>
<td>2 (c) Pensions</td>
<td>1.62%</td>
<td>1.53%</td>
<td>1.52%</td>
<td>1.54%</td>
<td>1.47%</td>
<td>1.38%</td>
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\(^8\) [http://kar.nic.in](http://kar.nic.in)
<table>
<thead>
<tr>
<th>2 (d) (i) Subsidies (Food, Transport, Housing &amp; Industry)</th>
<th>0.63%</th>
<th>0.61%</th>
<th>0.64%</th>
<th>0.64%</th>
<th>0.62%</th>
<th>0.54%</th>
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<tr>
<td>2 (d) (ii) Power Subsidy</td>
<td>0.81%</td>
<td>0.85%</td>
<td>0.85%</td>
<td>1.95%</td>
<td>1.74%</td>
<td>1.35%</td>
<td>0.81%</td>
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<tr>
<td>2 (e) Major O&amp;M (Roads, Buildings &amp; Irrigation)</td>
<td>0.36%</td>
<td>0.39%</td>
<td>0.45%</td>
<td>0.38%</td>
<td>0.41%</td>
<td>0.41%</td>
<td>0.42%</td>
</tr>
<tr>
<td>2 (f) Devolution to ULBs</td>
<td>0.44%</td>
<td>0.52%</td>
<td>0.50%</td>
<td>0.57%</td>
<td>0.56%</td>
<td>0.56%</td>
<td>0.58%</td>
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<tr>
<td>2 (g) Other O&amp;M (Edn, Health, RD, WS. Agri, Forest)</td>
<td>1.58%</td>
<td>1.77%</td>
<td>1.70%</td>
<td>1.56%</td>
<td>1.76%</td>
<td>1.85%</td>
<td>1.95%</td>
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<tr>
<td>2 (h) Administrative Expenditure</td>
<td>0.49%</td>
<td>0.43%</td>
<td>0.43%</td>
<td>0.39%</td>
<td>0.36%</td>
<td>0.34%</td>
<td>0.31%</td>
</tr>
<tr>
<td>2 (i) Other Revenue Expenditure</td>
<td>2.64%</td>
<td>2.86%</td>
<td>3.05%</td>
<td>2.99%</td>
<td>2.75%</td>
<td>2.52%</td>
<td>2.31%</td>
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<tr>
<td>3. Revenue Deficit</td>
<td>2.45%</td>
<td>1.49%</td>
<td>2.11%</td>
<td>2.23%</td>
<td>1.75%</td>
<td>0.75%</td>
<td>-0.42%</td>
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<tr>
<td>4. Capital Receipt</td>
<td>0.15%</td>
<td>0.16%</td>
<td>0.16%</td>
<td>0.17%</td>
<td>0.15%</td>
<td>0.13%</td>
<td>0.11%</td>
</tr>
<tr>
<td>5. Capital Expenditure /*</td>
<td>1.79%</td>
<td>1.66%</td>
<td>1.56%</td>
<td>1.65%</td>
<td>1.69%</td>
<td>1.85%</td>
<td>2.41%</td>
</tr>
<tr>
<td>6. Fiscal Deficit</td>
<td>4.50%</td>
<td>3.66%</td>
<td>4.03%</td>
<td>4.35%</td>
<td>4.22%</td>
<td>3.70%</td>
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<td>7. Total Debt Stock</td>
<td>27.66%</td>
<td>25.77%</td>
<td>25.77%</td>
<td>26.86%</td>
<td>26.39%</td>
<td>26.86%</td>
<td>26.57%</td>
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<td>8. Debt Service</td>
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<td>2.82%</td>
<td>2.85%</td>
<td>3.01%</td>
<td>3.02%</td>
<td>3.22%</td>
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<td>9. Salary+Pension+Interest</td>
<td>8.56%</td>
<td>8.72%</td>
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<td>10. Consolidated Revenue Deficit</td>
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<td>2.01%</td>
<td>2.63%</td>
<td>2.80%</td>
<td>2.49%</td>
<td>.49%</td>
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<td>11. Consolidated Fiscal Deficit</td>
<td>5.57%</td>
<td>5.44%</td>
<td>5.81%</td>
<td>5.87%</td>
<td>5.10%</td>
<td>3.82%</td>
<td>2.76%</td>
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<tr>
<td>12. Consolidated Capital Expnd.</td>
<td>2.86%</td>
<td>3.59%</td>
<td>3.49%</td>
<td>3.25%</td>
<td>2.77%</td>
<td>2.46%</td>
<td>2.71%</td>
</tr>
<tr>
<td>13. Consolidated Interest</td>
<td>2.53%</td>
<td>2.84%</td>
<td>2.87%</td>
<td>3.02%</td>
<td>3.14%</td>
<td>3.21%</td>
<td>3.16%</td>
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<td>14. Consolidated Debt Stock</td>
<td>29.90%</td>
<td>30.61%</td>
<td>30.61%</td>
<td>32.65%</td>
<td>32.35%</td>
<td>32.21%</td>
<td>31.03%</td>
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<tr>
<td>15 Off-budget Borrowings</td>
<td>1.06%</td>
<td>1.93%</td>
<td>1.93%</td>
<td>1.60%</td>
<td>1.08%</td>
<td>0.61%</td>
<td>0.29%</td>
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</tbody>
</table>

/* Capital Expenditure is actual expenditure on capital formation, and excludes debt servicing of off-budget borrowing, which is included in capital expenditure under budgetary definitions. Thus, in this table, the fiscal deficit does not equal the revenue deficit plus capital expenditure plus net loans advanced.*/
1.8 Medium-Term Fiscal Plan for Karnataka, 2006-2010

The Karnataka government has tabled the Medium Term Fiscal Plan for 2006-10 before the legislature in compliance with Section 3 of the Karnataka Fiscal Responsibility Act (2002).

The Plan explains the fiscal and revenue reforms undertaken by the government. Revenue projections have been made and the expenditure management strategies have been explained. Expenditure projections have also been made a la revenue projections.

It all started with the State government desiring to adopt a legislative path to ensure fiscal correction. In 2002, the "Karnataka Fiscal Responsibility Act" (KFRA) was enacted. Karnataka’s FRA went beyond a debt-centric view to emphasize fiscal responsibility as a developmental responsibility. The KFRA mandated that the State finances must be viewed from a medium term perspective. It expected ensuring transparency in fiscal operations. Debts and deficits were to be given a consolidated treatment. In order to meet the exceptional circumstances the Act provided certain exceptions. Apart from specifying general principles of financial responsibility, the KFRA laid certain time specific milestones. The most important among them are as follows:

* Revenue deficit to be eliminated by March 2006.
* Fiscal deficit to be not more than three percent of the estimated gross state domestic product by 2005-06.

9 http://kar.nic.in
In order to achieve the said milestones, the KFRA expected the state to bring out a Medium Term Fiscal plan, which was to disclose the resources and allocations over a medium term in the context of the last two years expenditure. Provisions were included in the KFRA to enforce fiscal discipline through measures such as:

- dovetailing the MTFP to the annual budget
- half-yearly review by the Finance Minister to be placed before the legislature
- offsetting of the fiscal impact of new policy decisions or additional expenditures
- disclosure of expenditure information especially on items like salaries, pensions, interests, grant in aid etc.

In order to meet the expenses arising out of emergencies like national security or natural calamity "Emergency Provisions' were incorporated in the Act itself. So far the state has come out with five MTFP documents.

In order to reduce the mounting burden of debt and contingent liabilities, the government enacted Karnataka Ceiling of Government Guarantees Act 1999 (KCGG Act). This Act mandated that all kinds of guarantees extended by government of Karnataka be brought to the knowledge of the legislature annually and further stipulated that the total guarantee extended by government during any year should not exceed 80% the total revenue receipts of the state one year prior to the preceding year. A guarantee
commission of 1% was to be levied on the institution seeking government guarantee which would be credited to a "Guarantee Redemption Fund". The accruals in the Guarantee Redemption Fund was expected to be used later to meet any contingent liability arising out of failure of any institution in meeting its debt servicing obligations. The KFRA Act stipulated that no government guarantee exceeding the limit stipulated under the KCGG Act was to be extended by the government.

Revenue & Expenditure Reforms Since 2002

The reform measures undertaken by the government of Karnataka, in brief, have been:

- The state government constituted a "Tax Reforms Commission" which recommended a number of reform measures to simplify tax administration.

- Sale Tax exemptions were restrained and tax rates were rationalized.

- The state switched over to VAT for most of the commodities from 1st of April 2005.

- In State excise taxes, the problem of non duty paid and illicitly produced alcohol was addressed through canalization of Indian made foreign Liquor (IML) and rectified spirit.

- Manufacturing of arrack was liberalized and at the same time, to ensure quality, third party quality check was introduced.
In so far as stamp duty on registration of properties was concerned, it was recognized that the higher rate of registration was a disincentive for prompt registration of properties. Hence stamp duty was reduced. Further the leakage of revenue through use of fake stamp papers was blocked through abolition of use of "Stamp Papers" during registration.

As regards non-tax revenue, reform measures were undertaken. A Revenue Reform Commission (RRC) was constituted to go into the various non-tax revenues, basis of their rate, fees, user charges etc. Based on the recommendations of the RRC the non-tax revenue of some of the departments was revised suitably.

Expenditure reforms were targeted towards reducing the expenditure pressure on account of salary, pension and interest payments. As a first step, an "Administrative Reforms Commission" was constituted to look into functioning of the various departments. More than 7,000 posts which were found redundant were abolished. Except for the sectors of education, health and internal security, recruitment in other departments was controlled through economy orders. On-going schemes were reviewed at the highest level and unnecessary and redundant schemes were dropped. In order to keep a control on the flow of funds, the whole treasury system was computerized.

With the help of the World Bank a "Public Finance Management and Accountability (PFMA) study was organized and this study brought out the various issues relating to budgetary controls on expenditure. The
study brought out the measures to be taken for improving the transparency in government transactions and reporting mechanisms.

- In addition the State constituted a “Fiscal Policy Analysis Cell” (FPAC) to facilitate the government in dealing with long term issues on resource generation as well expenditure control.

- Interest payment was major expenditure pressure. The burden of interest payment was reduced through swapping of Rs 5643 crores of loans with low cost loans. This resulted in savings of more than Rs 2000 crores.

- In addition the stipulation in the KFRA Act that fiscal deficit was to be restricted to 3% of the GSDP helped containing the debt burden.

Fiscal Correction in the Recent Past

As a result of these measures fiscal correction took place in Karnataka in 04-05, two years well ahead of what was stipulated in the KFRA Act. In 2004-05 revenue deficit was eliminated and a revenue surplus of Rs 1638 crores was registered. In addition fiscal deficit for 04-05 was well below the stipulated 3% of GSDP.

The performance has been repeated in 2005-06. The provisional figures available for 2005-06 indicate that a revenue surplus of Rs 1187 crores has been achieved. The fiscal deficit is estimated to be 2.85% of GSDP. The falling tax to GSDP ratio of the State has been corrected over the last 5 years and it stands now at 10.3%. State’s efforts in reducing expenditure on
salaries, pension and interests are in line with the fiscal correction path indicated by TFC which prescribed that salary expenditures relative to revenue expenditure net of interest payments and pensions should not exceed 35%.

Benefits from Fiscal Correction
The State has gained from fiscal correction. It is able to fund projects with its own resources. The per capita plan expenditure of Karnataka is the highest in the country at Rs 2429. The plan size of Karnataka for 2005-06 was the second highest in the country and was Rs 13,555 crores. The support of own resources to plan (BCR) of Karnataka is the highest in the country. The state has not utilized the “ways and means facility” over the last two years. The total expenditure on salary, pension and interest in 2005-06 (RE) accounted for 41% of its resources. The improved financial position has enabled the state to reduce the burden of off-budget borrowings. It has become possible for the state to invest in capital assets.

The Eleventh Finance Commission (EFC), to encourage the States to adopt fiscal correction measures, announced some incentives. Under this scheme devised by EFC, RD/RR was identified as the monitor-able parameter, and this was to be reduced by 5% annually during the award period. All Indian States were expected to enter into an MOU with the GOI which specified the fiscal correction path; the MOU also indicated the incentive to be given to the fiscally correcting state in case the target correction was achieved. An incentive fund was created by government of India on the recommendation of
EFC and the States were to get an incentive from this fund depending on their fiscal performance. Karnataka is one of the few States which could reduce the RD/RR by 5% annually and for this performance it received an incentive of Rs 286.15 Cr from GOI. The strategy adopted by EFC proved beneficial to Karnataka although it did not result in major fiscal correction on the part of other Indian States. The Twelfth Finance Commission (TFC) again focused on fiscal imbalance in Indian States and the need to correct it. In order to promote the States to adopt fiscal correction measures, the TFC recommended two debt relief measures:

- As a first relief measure it recommended that the Central loans of the State be consolidated and rescheduled in case the State enacted the fiscal responsibility legislation as per the broad guidelines given by the TFC.

- The second relief measure was that in case the state reduced its revenue deficit and contained its fiscal deficit as per the fiscal reforms path contained in their respective Fiscal Responsibility Act then the repayment due of the central loan for that particular year would be waived.

These two recommendations have benefited Karnataka state. The State enacted KFRA Act as early as 2000. The revenue deficit has been wiped out and fiscal deficit was contained to less than 3% in 2004-05 itself. On account of this the State was given debt rescheduling benefit of Rs 304 crores in
2005-06 and further the Central loans owed by it to an extent of Rs 358.33 crores in 05-06 have been waived.

Conclusion
Thus all the three aspects — normative, positive and applied are immensely useful for policy formulation. However, the present study pertains to the analysis of all aspects of public expenditure as analysis of all aspects of public expenditure attains special significance in the case of developing countries like India wherein governments have effected a paradigm shift in their policy stance. An observation of growth and pattern of government expenditure over a period of time would convey something about the usefulness of government expenditure in meeting the changing demands of the public; it will also convey if the intensity of public need is reflected in the prevailing expenditure pattern. Government expenditure, if directed to other areas in which public demand is on the lower side, does not maximise the welfare level. Hence there is a need to pursue the present type of study in the wake of new responsibilities assumed by the thrust on the state during the last two decades. This will help in deducing the nature of prevailing government activity and extending suggestions if any for changes. Hence the actual growth in government expenditure in case of Karnataka and its behaviour during the past fifteen years is attempted in the chapters that follow.