# EXECUTIVE SUMMARY

## Background

In Karnataka, fiscal reforms and consolidation were brought to the forefront with the State Government formulating the first Medium Term Fiscal Plan (MTFP) for the period 2000-05 based on broad parameters of fiscal correction laid down by the Eleventh Finance Commission (EFC). MTFP became a rolling annual document and the fiscal targets and policies set out in MTFP were dovetailed to the annual budgetary exercises to operationalise the restructuring plan. Karnataka was the first State to enact (September 2002) Fiscal Responsibility Act (FRA) providing statutory backing to MTFP. The Act aims at ensuring fiscal stability and sustainability, enhance the scope for improving social and physical infrastructure and human development by achieving revenue surplus, reducing fiscal deficit, removing impediments to effective conduct of fiscal policy and prudent debt management through limits on borrowings, debt and deficits, greater transparency in fiscal operations by the use of medium-term fiscal framework.

By adhering to the policy changes in revenue generation strategies and expenditure control envisaged in MTFPs, the State achieved the fiscal targets laid down in the Act one year ahead, with the year 2004-05 ending in revenue surplus and fiscal deficit for the year at less than three *per cent* of GSDP. During the period 2005-09 also, the State continued to maintain the revenue surplus and kept the fiscal deficit relative to GSDP below the limit laid down under the Act. Outstanding guarantees given by the Government were within the limit prescribed under the Karnataka Ceiling to Government Guarantees Act. The ratio of fiscal liabilities to GSDP continued to decline from 2004-05 and was around 27 *per cent* in 2008-09. As a result of these achievements, the State received the full benefit of incentive grants of Rs 286 crore for the EFC award period. Under GOI's scheme of States' Debt Consolidation and Relief Facility (DCRF) recommended by the Twelfth Finance Commission (TFC), the State got the benefit of interest relief of Rs 1,051 crore for the period 2005-09 along with waiver of GOI loan of Rs 1,433 crore.

The civil audit report of the Comptroller and Auditor General (CAG) of India hitherto included two chapters on State finances. In the scenario of increased emphasis on public financial management particularly in the aftermath of FRA, a stand alone report on State Government finances is considered appropriate by the CAG. Accordingly, from the report year 2009 onwards, it is decided to bring out a separate volume titled 'Report on State Finances'.

## The Report

Based on the audited accounts of the Government of Karnataka for the year ending March 2009, this report provides an analytical review of the annual accounts of the State Government. This report is structured in three chapters.

**Chapter 1** is based on the audit of Finance Accounts and makes an assessment of Government of Karnataka's fiscal position as at 31 March 2009. It, *inter-alia*, provides an insight into trends in committed expenditure, borrowing pattern besides, a brief account of Government of India funds transferred directly to the State implementing agencies through off-budget route.

**Chapter 2** is based on the audit of Appropriation Accounts, gives description of appropriations and the manner in which the allocated resources were managed by the service delivery departments.

**Chapter 3** is an inventory of Karnataka Government's compliance with various reporting requirements and financial rules.

The report also has an appendage of additional data collated from several sources in support of these findings.

## Audit findings and recommendations

### Fiscal position

The fiscal position of the State viewed in terms of trends in deficit indicators revealed deterioration in 2007-08 and 2008-09 relative to 2006-07 as revenue surplus declined and fiscal and primary deficits increased.

The deterioration in fiscal performance during 2007-09 was on account of a relatively lower growth rate in the State's own resources due to global economic slow down and higher expenditure on salaries and pensions on account of implementation of State's fifth pay commission award.

### State's own resources

The ratio of State's tax revenue to GSDP remained more or less constant during the period. However, the ratio of non-tax revenue to GSDP declined from three *per cent* in 2004-05 to one *per cent* in 2008-09 due to inadequate cost recoveries from non-merit public services. *A de novo review of user charges and a radical rationalisation of levies is necessary.*

### Revenue expenditure

The revenue expenditure was around 80 *per cent* of the total expenditure in 2008-09. Non-plan revenue expenditure (NPRE) constituted 75 *per cent* of total revenue expenditure and it exceeded the normative projection of TFC for the State by Rs 7,555 crore (32 *per cent*) for the year. Salary expenditure, pension liabilities, interest payments and subsidies together constituted around 71 *per cent* of NPRE. Expenditure on salaries and pensions witnessed substantial increase during 2007-09 due to implementation of the State's fifth pay commission award.

*As the expenditure on salaries and pensions is expected to stabilize in the coming years as stated in the State's MTFP, the State Government should take action to restrict the other components of NPRE by phasing out implicit subsidies and resort to need based borrowings to cut down interest payments.*

**Adequate thrust to development expenditure**

The share of expenditure on general services (considered non-developmental in nature) in total expenditure decreased from 33 *per cent* in 2004-05 to 24 *per cent* in 2008-09, while that of social services increased from 27 to 35 *per cent*. The share of economic services increased from 35 *per cent* in 2004-05 to 41 *per cent* in 2006-07 but showed declining trend thereafter and was 34 *per cent* in 2008-09.

The fiscal space created by adhering to fiscal targets laid down in FRA and MTFPs and debt consolidation enabled the Government in reprioritizing its expenditure in favour of social and economic services and other social security measures during the period 2006-09, thus creating an environment for better delivery of essential services.

The aggregate expenditure as a percentage of GSDP in Karnataka (19.49 *per cent*) was marginally lower than the all States average (19.86 *per cent*) in 2008-09. However, there was adequate priority for social sector expenditure compared to the National average. The *per capita* expenditure in all categories viz., development expenditure, social service expenditure and capital expenditure was higher than the National average, indicating effective fiscal capacity of the State.

**Quality of capital expenditure**

Repayment of off-budget borrowings (Rs 8,595 crore) during 2004-09 was treated as capital expenditure. The State Government in compliance with the commitment in MTFP gradually phased out off-budget borrowings resulting in their complete elimination in 2008-09.

Funds aggregating Rs 1,107 crore remained blocked in projects pending completion as at the end of 2008-09. *There is a need to review the existing guidelines to bring them in line with the current concerns so that there would be a gradual change-over from detailed procedural controls to controls based on systemic checks and balances.*

**Review of Government investments**

The State invested Rs 10,820 crore in Government companies / Statutory corporations which were under perennial loss during 2004-09. Return on investment during the period was negligible. *The State Government should ensure better value for money in investments, otherwise high cost borrowed funds will continue to be invested in projects with low financial return. Adequate evaluation mechanisms need to be put in place to ensure that non-viable projects are filtered out.*

**Cash management**

Surplus cash balance, mainly due to market borrowings of Rs 7,417 crore raised during the last quarter of 2008-09 was invested in fourteen days treasury bills at an interest rate of five *per cent* per annum on an average as against interest paid at an average rate of seven *per cent* per annum on market borrowings resulting in net interest burden of Rs 41.85 crore up to the end of June 2009. *The State Government should resort to borrowings based on necessity and affordability rather than availability.*

**Oversight of funds transferred directly from the Union to the State implementing agencies**

The Central Government transferred a sizeable quantum of funds (Rs 2,437 crore during 2008-09) directly to the State implementing agencies for implementation of Central plan schemes. Funds flowing directly to the implementing agencies through off-budget routing inhibits FRA requirements of transparency and therefore, escape accountability. There is no single agency monitoring its use and there is no readily available data on the amounts spent in any particular year on major flagship and other important schemes. *A system has to be put in place to ensure proper accounting of these funds and the updated information should be validated by the State Government as well as the Accountant General (Accounts & Entitlement).*

**Financial management and budgetary control**

There was an over-all unspent provision of Rs 13,660.83 crore off-set by an excess expenditure of Rs 65.85 crore over provision during 2008-09. The excess expenditure requires regularisation under Article 205 of the Constitution of India. Large unspent provisions were in areas viz., urban development, water resources, debt servicing, public works, finance, agriculture and horticulture, etc. There were also instances of inadequate provision of funds and unnecessary/excessive re-appropriations. Besides, there was a rush of expenditure at the end of the year. In many cases, the anticipated unspent provisions were either not surrendered or surrendered on the last two days of the year leaving no scope for utilizing these funds for other development purposes. *Budgetary controls should be strictly followed to avoid such deficiencies in financial management. Last minute fund releases and issuance of re-appropriation/surrender orders should be minimised.*

**Financial reporting**

The State Government's compliance with various rules and regulations, procedures and directives was unsatisfactory as evident from huge pendency of utilization certificates for grants given to various institutions. The Government provided grants-in-aid to various bodies and institutions without ensuring that expenditure there from was incurred for the intended purposes. *To improve accountability and transparency further grants should not be provided to institutions which failed to submit utilization certificates within the stipulated time.* Delay was noticed in submission of *pro forma* accounts by departmentally managed commercial undertakings. There were instances of losses and misappropriations. *The departmental enquiries in such cases should be expedited to bring the guilty to book.* Internal controls should be strengthened to prevent such cases in future.