PUBLIC EXPENDITURE AND EMERGING FISCAL POLICY SCENARIO IN INDIA

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1. Introduction

This paper seeks to analyse the role of public expenditure policy and management as key instruments in the pursuit of the fiscal policy goals in India. The role of public expenditure in the fiscal policy goals of growth, equity and stability, has varied across different phases of economic development in India. The historical importance of public expenditure lies in the mixed economy model adopted after Independence in India whereby the government assumed the primary responsibility of building the capital and infrastructure base to promote economic growth. The concerns regarding equity and poverty alleviation after two decades of Independence added another important dimension to public expenditure in terms of redistribution of resources. The inadequate returns on capital outlays and the macroeconomic crisis of early Nineties arising out of high fiscal deficit shifted the focus of public expenditure to efficiency in its management for facilitating adequate returns and restoring macroeconomic stability. While the fiscal policy goal of stability could be achieved, the *modus operandi* of public expenditure management through curtailing capital expenditure raised concerns about infrastructure investment and its impact on the long-term growth potential of the economy. Furthermore, stagnating revenue mobilisation in particular and some upward movements in expenditures led to a reversal of the fiscal stabilisation process since the second half of the Nineties. An improved fiscal performance during 2003-04 engendered by containment of the non-plan expenditures and supported by high revenue mobilisation on the back of buoyant real activity paved the way for renewed commitment towards fiscal consolidation in India.

Against this backdrop, this paper would analyse the behaviour of public expenditure aggregates and their management in India in the context of fiscal policy objectives set out by the government. Accordingly, the paper is schematised as follows: After setting out the theoretical underpinnings and an analytical framework of public expenditure management in Section 2, Section 3 would discuss the imperatives to fiscal policy reforms and public expenditure policy and management in India. Section 4 would analyse the trends in the government expenditure aggregates in India followed by an evaluation of their behaviour in the context of fiscal policy goals in Section 5. The recent developments in the government finances in India along with an assessment of the emerging fiscal scenario are discussed in

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Section 6. Section 7 presents some future perspectives in the management of public expenditure in India. Section 8 presents few concluding observations.

2. A framework for public expenditure analysis

2.1 Theoretical underpinnings

Traditionally public expenditure represents a form of government intervention designed to promote allocative efficiency through correction of market failures, redistribute resources equitably and promote economic growth and stability (Musgrave, 1959). The redistributive powers of the state, through public expenditure, emanates from the normative arguments in favour of greater equality (Marshall, 1950; Rawls, 1971).

The level and composition of public expenditure can have conflicting implications for diverse macroeconomic considerations, *viz.,* growth, inflation, and the Balance of Payments. Balance of Payments and inflation problems often require a fiscal contraction to contain aggregate demand, and the experience has been that adjustment has tended to affect the expenditure side of the budget more than the revenue side. Moreover, in face of the constraint imposed by high interest payments, especially in the heavily indebted countries, and the resilience of some other current outlays such as defense and social spending, capital spending, in general, and infrastructure projects, in particular, have borne the burden of expenditure adjustment. While halting or delaying public investment projects may offer sizeable immediate dividends for public finances, the Balance of Payments, and inflation, a price could be paid in the longer term in the form of lower growth, especially if more productive investments are affected.

Structural policies are a response to the need to ensure that, while stabilisation measures may be harmful to economic growth in the short term, the longer-term growth objective is not jeopardised. While this requires sound stabilisation policies, it is also dependent upon policies to stimulate the supply side of the economy. As regards public expenditure, the challenge is to secure a level of spending consistent with macroeconomic stability, and then restructure expenditure as part of a systemic reform package aimed at raising the sustainable growth rate by promoting domestic saving, productive investment, and the efficiency of resource allocation. However, the notion of sustainability extends beyond macroeconomic stability; growth may be stable, but if little progress is made in terms of equity gains, which are also a function of public expenditure, this may undermine the social and political sustainability of growth.

In the Keynesian paradigm, public expenditure promotes growth through upward shift in real effective demand in an economy operating at less than full employment level. Empirically, however, it has been found that the link between public expenditure and growth is contingent upon the nature of expenditure. Typically, studies have found that current spending does not have any significant influence on the real growth of the economy whereas capital spending particularly

on health, housing and welfare has significant impact on growth (Diamond, 1989). Similarly, in the framework of endogenous growth theory (Romer, 1994), public spending on investments in areas like infrastructure, human capital, science and technology exerts positive influence on economic growth (Tanzi and Zee, 1997).

Traditional demand management programmes typically focus on the size rather than the structure of reduction in deficit, *i.e.* the quantity of adjustment rather than its quality. Tanzi (1987) has argued that a good stabilisation programme must be implemented with fiscal measures, which are durable and efficient, and if attention is not paid to this, stabilisation programme may achieve successes, which are only short lived. Furthermore, if fiscal adjustment is carried out with well-chosen specific measures, it may induce an important supply response in the economy to reduce the magnitude by which the fiscal deficit would need to be contained. Tanzi clearly distinguishes between a microeconomic approach and macroeconomic approach to stabilisation programme. The former refers to an approach, which explicitly recognises both demand and supply management, while the latter refers to demand management alone. When the focus is only on demand management, whether a country reduces its fiscal deficit by raising revenue or by cutting expenditure is inconsequential. The observance of the fiscal ceilings is the most essential fiscal element of such a programme.

The theory of "fiscal federalism" argues that because the lower levels of government are constrained in their macroeconomic policies (since monetary policy is centralised), the central government should have the basic responsibility for macroeconomic stabilisation, such as using the central budget to alleviate demand shocks (Oates, 1972, 1999). Local governments, in contrast, should be responsible for providing public services and redistributing incomes within their jurisdiction, according to the particular political preferences of their constituents. In this regard, budgetary expansion can be restricted by institutional mechanisms. For instance, a balanced-budget rule, like the proposed "balanced-budget amendment" in the US or the expenditure ceiling in the EU, prevents expenditure from being expanded without commensurate increase in revenue. If revenue cannot be increased, changes in the budget can only occur through reallocation of expenditure from one programme to another.

2.2 An analytical framework

Fiscal policies across economies, while shaped by country-specific histories, can nevertheless be mapped generally into a standard fiscal framework. Typically, fiscal policy sets growth, stability and equity as the goals where public expenditure management is one of the main operating instruments in pursuing these goals. In this pursuit, public expenditure management plans to achieve intermediate targets set for overall expenditure control, strategic resource allocation as per the policy priorities and efficient, effective and responsive operational management of expenditure.

With a view to understand as to how public expenditure management serves as a central instrument in pursuit of fiscal policy goals, it is useful to analytically classify the various components of government expenditure in terms of their influence on various segments of economy. The government expenditure typically consists of expenditure on general, social and economic services. In practice, these expenditures are also classified under current and capital heads where current expenditure represents the consumption and capital expenditure represents asset creation by the government. Alternately, the government expenditure can also be classified in terms of developmental and non-developmental categories so as to assess their welfare impact. The developmental expenditure mainly includes spending on economic services (agriculture, industry, energy, communication, transport, science, technology and environment) and social services (education, health, employment, nutrition, housing and others). The remaining categories such as government administration, interest payments, pensions, defence and other non-productive services constitute non-developmental expenditure.

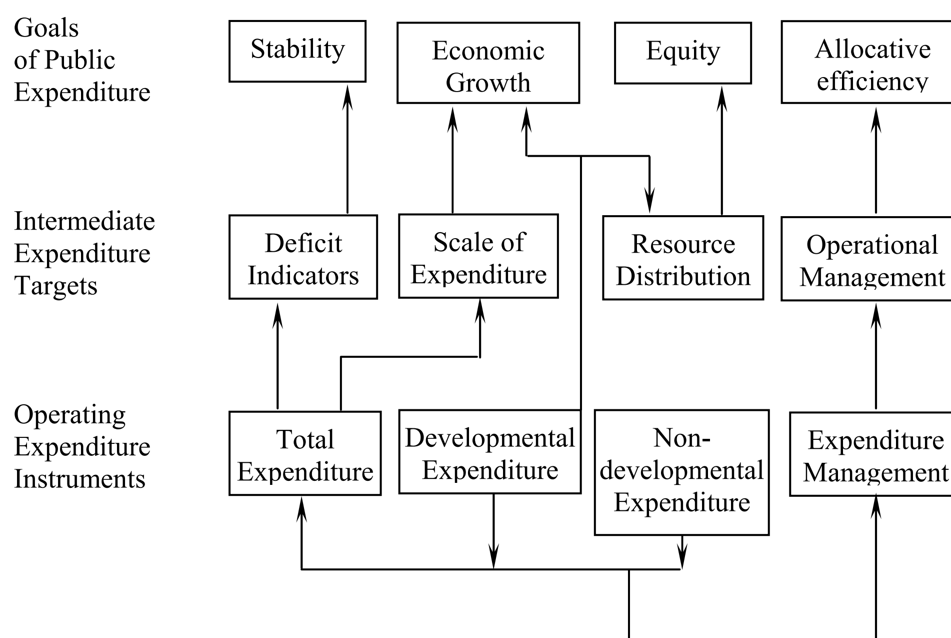
Given the above classification of government expenditure, it is possible to identify the role of each of the above components of expenditure towards achievement of the fiscal policy goals through the operation of intermediate targets as schematised in Exhibit 1. It may be noted, however, that the interrelationships shown in the exhibit is a simplified framework just indicating directions where the responsiveness of fiscal policy goals is more to intermediate targets and expenditure policy operating instruments. The economic growth is normally more responsive to developmental expenditure, in general, and capital outlays, in particular. The achievement of equity goal depends on the social expenditure such as poverty alleviation, education, health and employment generation which also forms developmental expenditures. Overall government expenditure affects macroeconomic stability through movements in deficit indicators. Thus, government expenditures have to be balanced so as to pursue the goals of growth and equity while at the same time keeping a vigil on the overall size of the expenditure to contain the deficit within levels consistent with macroeconomic stability.

In the above context, it may be noted that the public expenditure *policy* essentially sets out the “goals” to be achieved while the management of public expenditure is instrumental in nature and focuses on “how” to achieve these goals. In terms of the framework devised by Premchand (2000), the objectives of public expenditure management, in general, can be schematised as follows (Exhibit 2).

The evolutionary pattern of the public expenditure management system in the early phase of development typically boils down to maximising the growth through higher allocations towards capital formation. The equity concerns in the growth process call for more spending on social sectors. These expenditure responsibilities are often met from the borrowed resources which creates a vicious cycle of debt, interest payments, deficit, and further debt. These dynamics indicate the unsustainability of the public finances which may spill over to adversely affect overall macroeconomic stability. With a view to break this vicious cycle, public expenditure management system need to be designed in an efficient and congruent

Exhibit 1

Fiscal Policy Operating Procedure and Public Expenditure



manner where all the objectives of fiscal policy are adequately addressed through a coherent policy package.

It may also be noted that while greater centralisation improves revenue mobilisation, expenditure management tends to be more effective with greater decentralisation. It follows, therefore, that the imposition of expenditure constraint needs to be based on bottoms-up rather than top-down approach, although the former needs to be consistent with the overall framework of expenditure management. In terms of sequencing, fiscal discipline or overall expenditure control needs to come first followed by resource allocation and operational efficiency objectives. One of the strategies followed to institutionalise expenditure management is by setting formal rules such as fiscal responsibility legislations put in place in a number of countries. While expenditure management normally yearns to follow the formal rules, a key part of expenditure management is to also recognise informal rules. It may be noted in this context that the implementation of such rules may often pose a policy dilemma where cutbacks in capital expenditures may adversely affect economic growth which in turn contributes to reduction in revenue leading to larger deficit. It is important, therefore, to note that the policy formulations should not be such that remedy would be worse than the disease (Pattnaik, 1996).

Exhibit 2

Effective Government	• Provision of services to the public within specified time and cost schedule • Achievement of allocative and technical efficiency • Ensuring that budgetary intent and outcome are congruent • Matching outlays with resources • Provision of management flexibility to the implementation agencies
Responsive Government	• Achievement of macroeconomic stability • Responsiveness to changing economic situations • Responsiveness to the changing needs of the client/consumer • Provision of a utilisation culture in *lieu* of a spending culture
Accountable Government	• Accountability for results • Provision of accurate information on the status of government finances

The public expenditure management, thus, has to follow some canons of public finance whereby sustainability is ensured by bringing the key deficit indicators within some thresholds. Ideally, revenue surplus should finance the capital and social outlays keeping the budget in balance. To achieve this implies continuous efforts to contain the magnitude of current expenditure, particularly unproductive ones, and once revenue surplus is achieved, the developmental and social spending should be enhanced keeping human development as one of the key priorities.

In the context of human development, a key role of public expenditure is to alleviate poverty. This becomes even more critical in the light of multidimensional sources of poverty which may call for multidimensional solutions (Sachs, 2005). Thus, clean water, productive soils and a functioning good health care system are just as relevant to development as any other economic issue. In this regard, Sachs has advocated a new method called "clinical economics", to underscore the similarity between good development economics and good clinical medicine. In this regard, it has been argued that the contemporary problems of poverty and human development call for "clinical" solutions where the policy measures are taken on the basis of proper diagnosis.

3. Imperatives to fiscal policy reforms and public expenditure management in India

Traditional budget making in the Indian context favours a revenue account surplus and deficit in capital account and lower overall balance. The implicit logic behind a deficit in capital account of the government budget is that capital expenditure is growth supportive. However, the capital account has been continuously in surplus since fiscal 1982-83 reflecting the emergence of large revenue deficit and decline in capital outlays. Moreover, the average returns on the capital outlays have been found to be lower than the average rate at which funds have been borrowed to finance the capital outlays (Pattnaik, 1996).

3.1 Need for prudent expenditure management in India

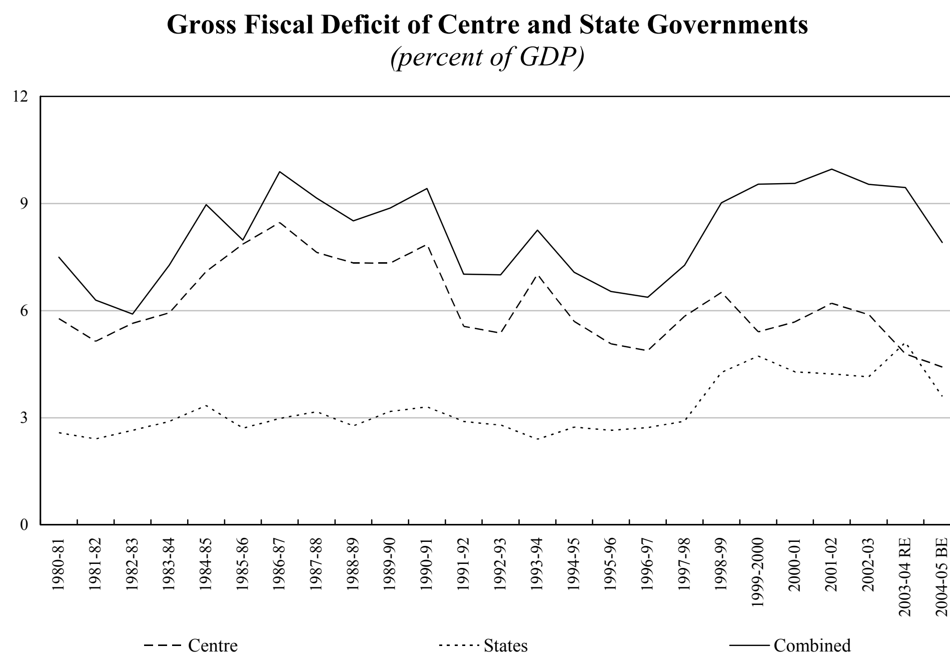
The cumulative impact of these developments was reflected in the deterioration of fiscal deficit of the central government during the late Eighties. On the other hand, in the face of borrowing restrictions, the expenditure of the state governments grew more or less in consonance with revenue mobilisation thereby preventing any unabated rise in deficits. Nevertheless, due to a rise in the centre's deficits, the combined deficit of the centre and the state governments increased significantly from 7.5 per cent of GDP in 1980-81 to 9.4 per cent in 1990-91 (Figure 1).

A closer analysis of the central government finances reveals that a widening of about two percentage points of GDP in gross fiscal deficit (GFD) emanated from the revenue deficit which widened from 1.4 per cent of GDP in 1980-81 to 3.3 per cent in 1990-91. The key factor behind the worsening of revenue and fiscal deficits was increase in interest payments which registered a rise of almost two percentage points of GDP over the same period. This reflected a vicious cycle of widening deficit, larger borrowings, increasing debt stocks, higher interest payments and further widening of deficit. The debt stock of the central government over the Eighties increased by around 14 percentage points of GDP to reach 55.3 per cent of GDP in 1990-91. In respect of state governments, though the revenue deficit widened by almost two percentage points of GDP, the rise in fiscal deficit could be contained at below one percentage point of GDP mainly due to compression in capital expenditure. The main factor behind the widening of revenue deficit of the states was the increase in non-interest revenue expenditure. The rise in interest payments was, however, of a lower order as they had limited and restricted access to borrowed resources.

A large and growing fiscal deficit of the government had macroeconomic implications in terms of sustainability of growth process. The mounting fiscal deficit in the Eighties was increasingly financed by the draft of financial surpluses of the households through statutory preemptions of resources from the financial sector at sub-market clearing rates. The Statutory Liquidity Ratio (SLR), which represents statutory investments by banks in government securities, was raised to its peak level

Figure 1

Gross Fiscal Deficit of Centre and State Governments
(percent of GDP)



of 38.5 per cent by 1990. Furthermore, the tendency of automatic monetisation of the fiscal deficit compromised effectiveness of monetary policy and fuelled inflation. This eventuated into a macroeconomic crisis spilling over to a balance of payments crisis in 1990-91 and thereby necessitating the measures towards fiscal consolidation.

The strategy of fiscal consolidation initiated in the early Nineties was a mix of measures towards revenue augmentation through tax reforms and expenditure compression. Given the limited improvement in revenue mobilisation, the fiscal consolidation during the first half of the Nineties was essentially achieved through expenditure containment. A series of expenditure management measures to check the built-in growth of expenditures as well as to bring about a structural change in the expenditure composition were announced in successive budgets of the central government since the early Nineties. The process included subjecting ongoing schemes to zero-based budgeting, rationalisation of manpower requirements in the government departments, review of all subsidies so as to introduce cost-based user charges wherever feasible, a review of the budgetary support to autonomous institutions and encouragement to PSUs for greater internal generation of resources.

Notwithstanding the wide range of measures, the expenditure compression was mainly effected in the capital expenditure. Notably, the capital outlay of the

centre declined from 3.0 per cent of GDP in 1986-87 to 2.1 per cent in 1990-91 and further to 1.0 per cent in 1996-97. Since then, there has been a significant reversal of the trend with a renewed focus of expenditure management. A major initiative towards institutionalising an expenditure management system was through constitution of Expenditure Reforms Commission (ERC) to look into various areas of expenditure correction. These included creation of national food stock along with cost minimisation of buffer stock operations, rationalisation of fertiliser subsidies through phased dismantling of controls, imposing a ceiling on government staff strength through a two-year ban on new recruitment, introduction of voluntary retirement scheme and redeployment of surplus staff. Endeavour was also made to promote transparency and curb growth in contingent liabilities by setting up the Guarantee Redemption Fund. As a part of these efforts, Administered Price Mechanism (APM) in the petroleum sector was dismantled from April 2002, restriction of fresh recruitment to one per cent of total civilian staff strength over the four years was placed from 2002-03 and a new pension scheme of defined contribution for new recruits was introduced from 2003-04.

In respect of the states, the fiscal imbalances turned adverse particularly in the second half of Nineties thereby necessitating initiation of reforms during this period at the state level as well. In part, this was also necessitated by sluggish central transfers to the states, introduction of reform linked assistance as a part of Medium-term Fiscal Reform Programme and adjustment programme of some of the states as linked to borrowings from multilateral agencies. The expenditure management programmes of the states included restrictions on creation of new posts, review of manpower requirements, lowering of establishment expenses and reduction of non-merit subsidies through better targeting.

3.2 Institutions for public expenditure management in India

A research study, which was instituted by Japan Bank for International Cooperation, assessed the structural as well as working aspects of public expenditure management (PEM) system in India in terms of a four-stage cycle, *viz*., from plan/programme/activity to budgeting (stage 1), from budgeting to execution (stage 2), from execution to evaluation (stage 3) and from evaluation to feedback (stage 4) (JBIC, 2001). The study commended the consultative policy formulation in the budgetary exercise in India but also noted lack of feedback on the outcome of outlays to the budget makers, the inherent policy rigidities resisting any sizeable intersectoral reallocations and absence of medium-term policies for non-plan budget items. The study also recognised the strengths of concretising outlays for the budget estimates six months' in advance, setting ceilings for non-plan and plan outlays as well as aligning investment decision making strictly as per the guidelines but notes lacunae in the form of lack of activity-wise scrutiny of the non-plan expenditure and absence of medium-term perspectives on ongoing allocations for the continuing activities. It also notes that the PEM in India has a predesigned system for monitoring physical progress of infrastructure sectors and major plan projects but

there is no monitoring of the physical progress of non-plan as well as socio-economic activities. In the case of plan outlays, physical targets are often unrealistic in relation to the financial allocations. Although there is budgeting for each activity and within each activity, different objects of expenditure are monitored through monthly accounts prepared by the Controller General of Accounts, the monitoring system seems to be accounts-oriented with weak internal auditing system. Furthermore, though the government's Programme Evaluation Organisation evaluates plan programmes and a pre-designed system exists whereby external and international donors evaluate programmes that they finance, a regular mechanism is absent for evaluating all programmes in a time bound manner.

4. Trends of public expenditure in India

The fundamental strategy for boosting growth in the Indian economy was to assign a lead role for the public sector in building the capital base of the country. The effect of Mahalanobis model, adopted in Second Five Year Plan (1955-56 to 1960-61) is visible in the capital formation in the public sector comprising central government, state governments and public sector undertakings.

4.1 An overview of public sector investment and consumption

Public sector investment and consumption expenditure have constituted important constituents of effective demand in the Indian economy. The investment process was initiated in the planning period with the public sector being in charge of the "commanding-height" of the industrial sector, representing infrastructure, heavy industries and defence that required heavy dozes of capital formation. Accordingly, public sector investment rate improved from the low level of 2.8 per cent of GDP in 1950-51 to 11.7 per cent in 1986-87 (Figure 2).

The spurt in public investment during the late Seventies reflected government's response to the second oil shock by expansionary adjustment through increased investment and reorienting investment for boosting oil production and removing infrastructural constraints. However, in the wake of two successive monsoon failures in 1986 and 1987, the government had to resort to expenditure cuts that affected capital formation. Since the mid-Eighties, the public sector capital formation slackened which, however, did not narrow the saving-investment gap of the public sector as the public sector saving deteriorated more rapidly than investment. The asset-wise distribution of public sector capital formation shows the predominance of investment in construction rather than machinery and equipment reflecting its greater accent on infrastructure (Table 1). A noteworthy feature has been a decline in the share of construction in the gross fixed capital formation in the public sector with a corresponding increase in that of machinery and equipment up to the Nineties which has somewhat reversed thereafter reflecting renewed emphasis on infrastructure.

Figure 2

Final Demand from the Public Sector
(percent of GDP)

12
9
6
3
0
Wage hikes
Expansionary Adjustment
to 2nd Oil shock
Commanding Heights
1951 1953 1955 1957 1959 1961 1963 1965 1967 1969 1971 1973 1975 1977 1979 1981 1983 1985 1987 1989 1991 1993 1995 1997 1999 2001 2003
Public Sector Investment
Public Sector Consumption

Table 1

Distribution of Gross Fixed Capital Formation in the Public Sector
(percent)

	Share of Construction	Share of Machinery and Equipment
1	2	3
1950-51	73.9	26.1
1960-61	63.7	36.3
1970-71	64.1	35.9
1980-81	58.8	41.2
1990-91	50.8	49.2
2000-01	58.4	41.6
2002-03	64.8	35.2

Public sector consumption has generally shown an upward trend up to the mid-Eighties reflecting expansion of the overall government sector. Since the mid-Eighties public sector consumption have shown sporadic episodes of expansion partly due to the revisions in wages and salaries of government employees. The rise in public consumption and decline in public investment have raised some concerns regarding the sustainability of the growth process particularly in the second half of the Nineties. Such an outcome in respect of public sector outlays was reflective of the shift in government's strategy for the development and growth process whereby the role of government was rationalised so as to allow a greater role for market forces. The increasing borrowings and monetisation of the government deficits, however, had serious implications on the overall investment and growth of the economy as manifested by the macroeconomic crisis of the early Nineties. This called for fiscal consolidation leading to a series of measures in respect of expenditure as well as revenue of the government. It may be noted that the revenue enhancement was constrained by the need to align the tax rates with international standards and the fiscal correction mainly came from the expenditure side.

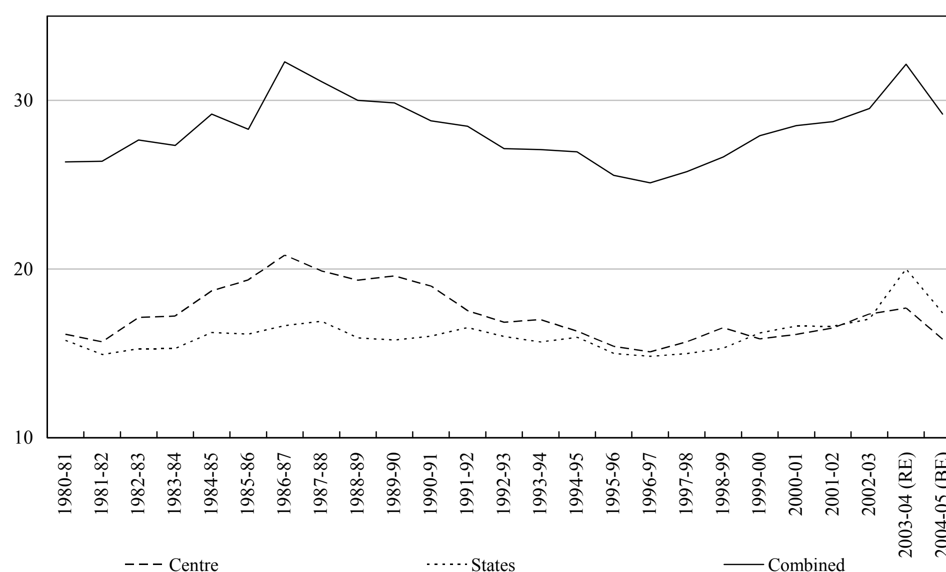
4.2 Government expenditure pattern

Government expenditure comprises expenditure on economic, social and general services. The pattern in government expenditure since the Eighties has been mainly influenced by a change in role of the government in the growth process, financing pattern of the deficits (debt and interest payments) and the need for fiscal consolidation. As noted above, the revenue mobilisation was constrained by the need for rationalisation of tax structure and aligning the tax rates with international standards. Despite the initiation of tax reforms in the early Nineties, in the Indian context, the typical "Laffer curve effect" did not fructify and expected increase in tax buoyancies did not occur. The tax-to-GDP ratio of the centre declined from an average of 9.9 per cent during the Eighties to 9.7 per cent in the first half of the Nineties. In this scenario, the only way out from the macroeconomic crisis was to undertake an expenditure compression strategy. Accordingly, the overall size of the government sector (centre and states) expenditure after reaching a peak of 32.3 per cent of GDP in 1986-87 showed a steady decline till first half of the Nineties (Figure 3). However, on account of predominance of committed expenses, curtailment could not take place in the revenue expenditure. The overall pattern in expenditure was primarily shaped by the central government while the states' expenditure remained stable at around 15-16 per cent of GDP.

As noted above, there has been a slowing down of public sector capital formation since the Eighties which is also reflected in the switch in pattern of government expenditure more towards revenue expenditure (Figure 4). The sharp increases in revenue expenditure reflected continued growth in non-plan expenditure on account of interest payments, subsidies, administrative and defence expenses.

Figure 3

Total Expenditure of Centre and the State Governments
(percent of GDP)



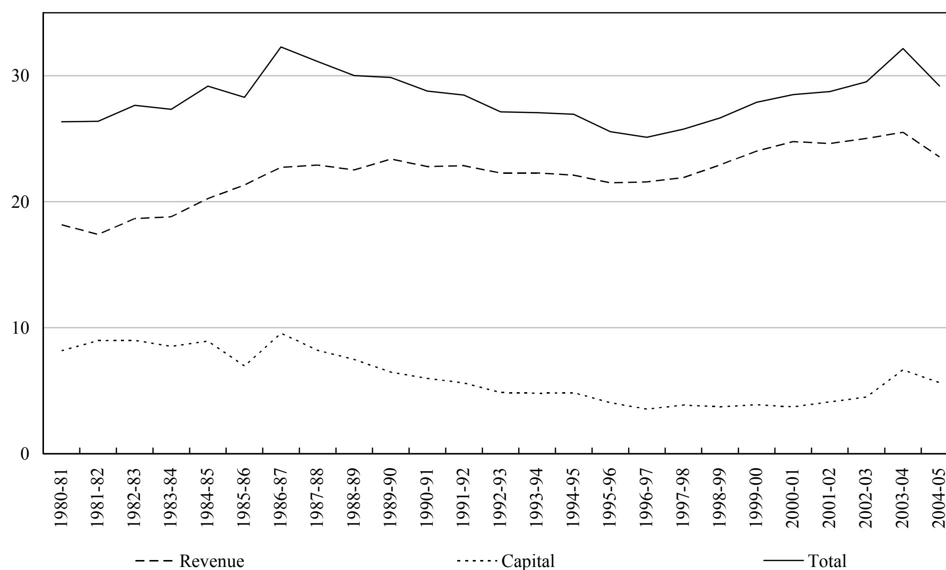
Interest Payments

The widening of fiscal deficit and consequent rise in debt stocks during the last two decades have resulted in mounting expenditure on interest payments. The debt-to-GDP ratio rose from 46.4 per cent of GDP at the beginning of the Eighties to around 62 per cent by the beginning of the Nineties. The fiscal consolidation process in the first half of the Nineties facilitated some control in the debt burden of government. However, the fiscal stress in the latter half of the Nineties again built up the debt burden with the debt-GDP ratio rising to around 77 per cent in 2003-04 (Figure 5).

As a result of the mounting debt burden of the government, interest payments registered substantial increases during the Eighties. The interest payments continued to increase despite a reduction in the combined debt-to-GDP ratio from 61.7 per cent of GDP in 1990-91 to 56.5 per cent in 1996-97, reflecting alignment of interest rates on government borrowings from sub-market to market related rates which led to a rise in the weighted average interest rate on market borrowings of both the centre and the state governments. The interest burden kept on increasing even in the second half of Nineties despite a softer interest rate regime reflecting impact of sizeable outstanding liabilities contracted at higher interest rates during the early part of the decade and also a return to rising deficits. The persistent rise in interest payments since the mid-Eighties has remained a cause of serious concern as they

Figure 4

Revenue and Capital Expenditure of Centre and the States
(percent of GDP)



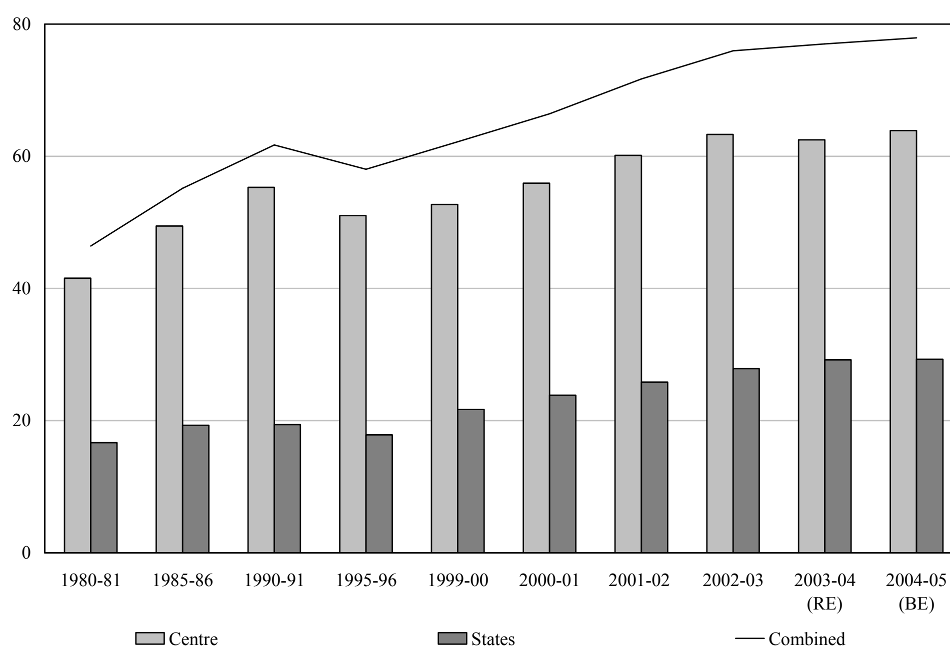
increasingly absorbed greater portion of revenue receipts (Figure 6). In respect of centre, interest payments were more than half of the revenue receipts in the late Nineties and early years of the current decade. It may be noted that the combined interest payments to revenue receipts ratio is lower than that of the centre reflecting the intergovernmental interest payments (by states to centre) which are netted out while calculating the combined interest payments.

Subsidies

Expenditure on subsidies is a crucial element of government expenditure particularly in the light of targeting poverty alleviation and the growing need to rationalise expenses for fiscal consolidation. The total burden of subsidies on government finances should take into account, in addition to the explicit subsidies, several implicit subsidies in the form of lower user charges for economic and social services provided by the government. According to an estimate, the quantum of total subsidies in India in the form of unrecovered cost of non-public goods and explicit subsidies on food and other items amounted to 4.2 per cent of GDP in 2003-04 whereas the explicit subsidies were placed at 1.6 per cent of GDP. The major element of explicit subsidies is food subsides which is determined by the minimum support price of foodgrains, operational efficiency of public distribution

Figure 5

Debt-to-GDP Ratio of the Centre and the States
(percent of GDP)



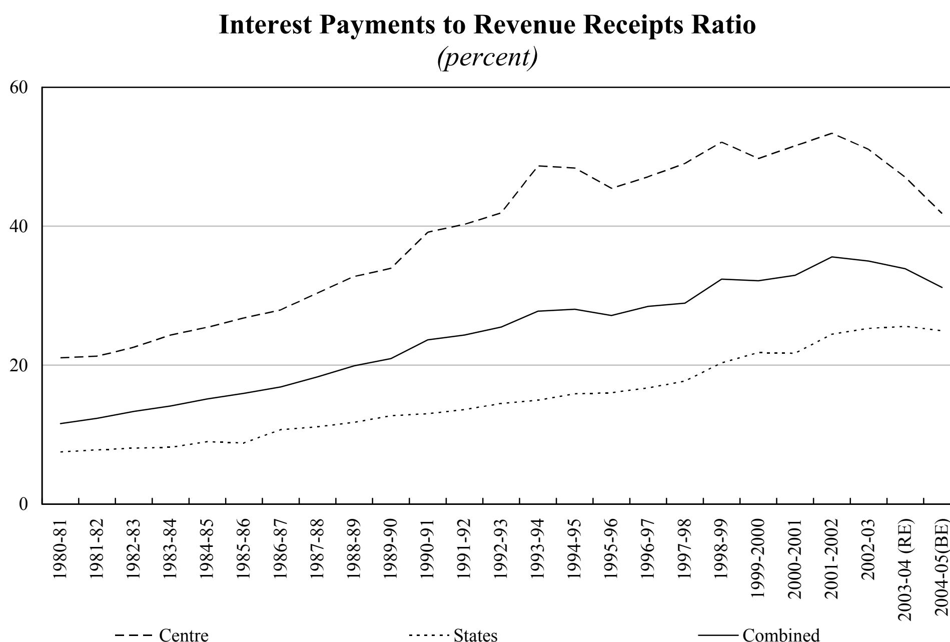
system and highly subsidised welfare schemes. The expenditure on fertilizers subsidies also formed a major chunk of total explicit subsidies; almost half of the total in 1991-92. The decontrol of fertilizers prices enabled a reduction in the expenditure on fertilizers subsidies to 0.5 per cent of GDP in 1993-94 from 0.8 per cent in the preceding year. Another major initiative, as a part of conscious efforts to curtail the expenditure on subsidies, was a phase out of the export subsidies in the beginning of the reform period. Accordingly, total explicit subsidies of the central government were reduced from 2.1 per cent of GDP in 1990-91 to 1.1 per cent by 1995-96.

Since the second half of the Nineties, however, the size of subsidies again started rising and increased to 1.6 per cent in 2003-04 from 1.1 per cent in 1995-96. With the dismantling of Administered Price Mechanism, petroleum subsidies were introduced in the union budget in 2002-03. As a result, subsidies under "others", which include petroleum subsidies, increased substantially to 0.3 per cent of GDP in 2002-03 from a negligible amount in the preceding year (Table 2).

Downward rigidity of subsidies is a worrisome feature as their unabated growth impacts revenue deficits adversely. Among the various components, the most critical one is the food subsidy which nearly recorded a ten-fold increase during the period 1990-91 to 2003-04 on account of carrying costs of piling

Figure 6

Interest Payments to Revenue Receipts Ratio
(percent)



excessive quantity of foodstocks. This has reflected the government's policy of encouraging food procurement through assured minimum support prices even while there was no commensurate off-take. The food subsidies could be an effective instrument to address the problems of economically deprived sections of the society; however, the proper targeting of such expenditure is a major concern. While data on state government subsidies are not available, the trend observed from other indicators like subsidy support to the State Electricity Boards (SEBs) shows that they also displayed similar movement. It led to misallocation of resources and also reflected inadequate revenue generating capacity through poor recovery of service costs, particularly in the non-merit goods sector.

Wages, salaries and pensions

The rising bill in respect of wages, salaries and pensions is considered to be an important element in the fiscal health of the government, particularly in the recent years. These components partly represent the committed expenditure obligations of the government. An intertemporal analysis of the behaviour of the expenditure on these components shows periodic spurts co-terminus with the implementation of wage revisions. For instance, the impact of Fifth Pay Commission Award by the central government could be seen in the rise of spending on wages,

Table 2

Central Government Expenditure on Subsidies

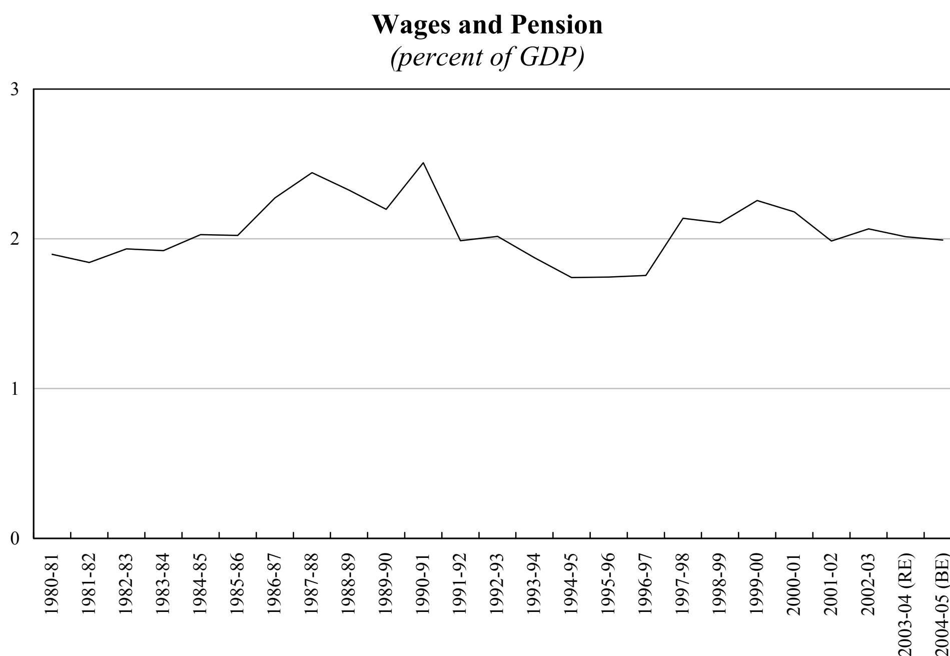
Year	Food	Fertilisers	Interest	Others	Total	Food	Fertilisers	Interest	Others	Total
	(Rupees crore)					*(percent of GDP)*				
1	2	3	4	5	6	7	8	9	10	11
1990-91	2,450	4,389	379	4,940	12,158	0.4	0.8	0.1	0.9	2.1
1991-92	2,850	6,100	316	2,987	12,253	0.4	0.9	0.0	0.5	1.9
1992-93	2,800	6,136	113	2,946	11,995	0.4	0.8	0.0	0.4	1.6
1993-94	5,537	4,562	113	1,393	11,605	0.6	0.5	0.0	0.2	1.4
1994-95	5,100	5,769	76	909	11,854	0.5	0.6	0.0	0.1	1.2
1995-96	5,377	6,735	34	520	12,666	0.5	0.6	0.0	0.0	1.1
1996-97	6,066	7,578	1,222	633	15,499	0.4	0.6	0.1	0.0	1.1
1997-98	7,900	9,918	78	644	18,540	0.5	0.7	0.0	0.0	1.2
1998-99	9,100	11,596	1,434	1,463	23,593	0.5	0.7	0.1	0.1	1.4
1999-2000	9,434	13,244	1,371	438	24,487	0.5	0.7	0.1	0.0	1.3
2000-01	12,060	13,800	111	867	26,838	0.6	0.7	0.0	0.0	1.3
2001-02	17,499	12,595	210	897	31,201	0.8	0.6	0.0	0.0	1.4
2002-03	24,176	11,015	750	7,592	43,533	1.0	0.4	0.0	0.3	1.8
2003-04	25,160	11,848	194	7,054	44,256	0.9	0.4	0.0	0.3	1.6
2004-05 RE	25,800	15,662	563	4,489	46,514	0.8	0.5	0.0	0.1	1.5
2005-06 BE	26,200	16,254	383	4,595	47,432	0.7	0.5	0.0	0.1	1.3

salaries and pensions to 2.3 per cent of GDP in 1999-2000 from 1.7 per cent in 1995-96 (Figure 7).

Capital Outlays

Capital outlays represent the expenditure undertaken by the government to build its investments. These investments enhance the productive capacity of the economy through provision of the infrastructure and capital goods. The actual impact of these investments on the growth process is magnified by the "crowding-in" impact on private investment. The impact of resource crunch and the need for fiscal correction has more often been in form of compression of capital outlays. Amidst the fiscal consolidation process in the early Nineties, the capital outlays of the centre declined to almost one per cent of GDP in 1996-97 from around three per cent in the mid-Eighties. There was some reversal of trend as the centre's capital outlays are estimated to recover to two per cent of GDP in 2004-05.

Figure 7

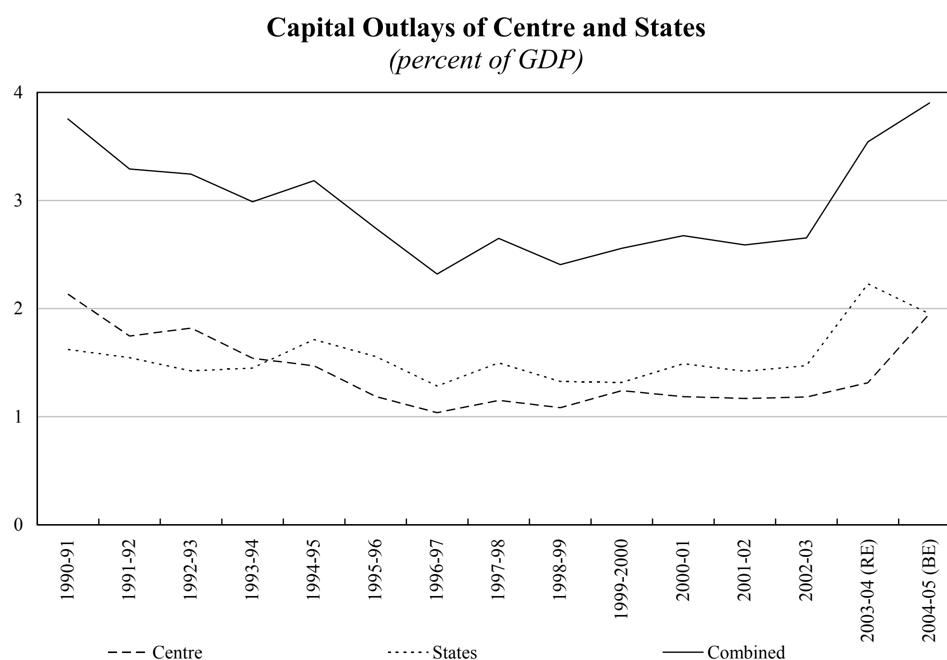


A noteworthy feature is that since 1993-94, the states' capital outlays have exceeded that of the centre reflecting the fiscal consolidation process launched by the centre. Furthermore, the upward kink of the state capital outlays in 2003-04, when it increased to 2.2 per cent of GDP from 1.5 per cent of GDP in 2002-03, reflected specific measures undertaken by a couple of states in respect of irrigation, flood control and energy (Figure 8).

It may be noted that since the early years of Independence, the investment profile has considerably changed. While in the earlier periods, direct capital formation from central budget used to be the norm, gradually the capital expenditure shifted to the states, central Public Sector Enterprises and other parastatals, changing the nature of government investment from direct creation of physical assets to financial assets in the form of equity and loans. Equity investments have also progressively declined as the public sector enterprises gradually began to finance their capital expenditure by raising resources directly from the market. The process received a further boost when in 1993 the government switched over to the policy of "disintermediation" of external assistance to central PSEs under which central PSEs are now allowed to access external funding directly rather than through the central budget. These developments have contributed to a decline in capital expenditure/investment of the central government (GoI, 2005).

Figure 8

Capital Outlays of Centre and States
(percent of GDP)



Defence

The central government also undertakes revenue and capital expenditures for defence purposes which act as a public good at the national level. An analysis of the behavior of defence outlays shows a steady increase from 2.5 per cent of GDP in 1980-81 to 3.4 per cent in 1987-88 before declining thereafter to 2.2 per cent in 2003-04.

5. Public expenditure policy and fiscal policy goals

The goals of fiscal policy in India over the years have been promotion of growth, equity and stability although the relative emphasis on each of them has varied across the different phases. Typically, the growth objective was assigned the prime importance during the first four decades of the planning era. As the government's attention shifted more towards poverty alleviation and employment generation, equity became the overriding objective thereafter. With the fiscal imbalances turning unsustainable since the early Nineties, the objective of restoring stability was accorded priority and the fiscal consolidation programme was undertaken to correct the fiscal imbalances. A common feature across all these phases was the adoption of public expenditure management as the key operating

fiscal policy instrument to pursue the objectives. Accordingly, public expenditure on capital formation undertook the responsibility of commanding heights to foster economic growth during the take-off phase in early part of the planning era. The shift in orientation of fiscal policy towards taking direct measures for addressing social and equity objectives reflected the concerns about the effectiveness of the "trickle-down" theory of growth strategy. Accordingly, public expenditure policy had to be reoriented towards undertaking of social expenditure in terms of direct measures on poverty alleviation and employment generation. In respect of capital outlays, the focus was shifted towards improving efficiency of their utilisation for capital formation and growth. Amidst the initiation of fiscal consolidation in the Nineties, however, expenditure compression measures had to bear the major burden of sharing the fiscal correction which led to a decline in capital outlays as a proportion of GDP.

5.1 Public expenditure and growth

Economic growth has been one of the abiding goals of fiscal policy in India and public expenditure management has been one of the key fiscal policy instruments to attain it. Empirical studies have, however, come out with debatable and competing results about the relationship between the two. Some studies have found a negative impact of government spending on output growth and, therefore, advocated small government sector for faster growth (Barro, 1991). On the other hand, there are studies, which distinguished government expenditure into government consumption and government capital accumulation and have found that government capital stock had a positive impact on productivity and growth (Ram, 1986 and Aschauer, 1989). It may also be noted that empirical support of capital expenditure leading to increase in growth has not only been debated in terms of disputes pertaining to classification between consumption and investment but also on the basis of counter intuitive results found in some studies that productive expenditures, when used in excess, turn unproductive and that several components of current expenditure, such as operations and maintenance may have higher rates of return than capital expenditure (Deverajan, Swaroop and Zou, 1996). In this context, a better classification of public expenditure would be in terms of dividing it into productive (growth inducing) and non-productive (growth-retarding) categories (Tanzi and Zee, 1997). In the case of India, studies have found a stable long run relationship between public sector expenditure and national income with the causality running strictly from the former to the latter, although in the short-run there is a trade-off between growth in public expenditure and income (Khunderakpam, 2003).

In India, it is observed that gross capital formation in the public sector (GCFPub) is positively related to gross domestic product (GDP) (at factor cost). An investigation of the relation between the two indicates that the elasticity of overall income with respect to public investment of the preceding year works out to about 0.90 over the period 1950-51 to 2003-04. A noteworthy feature, however, is that this

is estimated to increase from 0.79 during the pre-reform period (1950-91) to 1.42 during the reform period so far (1992-2004) (Exhibit 3). The benefits of the capital stock accumulation built up over the years are reflected in the improved productivity of capital formation in the public sector in the post reform period. The large stock of capital formed by public sector investment remained underutilized as the regulatory regime stifled optimum mix of the public and private sector operations. The initiation of reforms in the Nineties provided a conducive environment for the private sector to increase investment and promote economic activity through better utilisation of public infrastructure.

Exhibit 3

GDP and Public Investment

Equation	Statistics
$Log\ (GDP) = 3.61 + 0.90\ log\ (GCFPub_{-1})$ $(20.9^*)\qquad (47.8^*)$	R^2 (bar) =0.98; – (1950-51 to 2003-04)
$Log\ (GDP) = 4.44 + 0.79\ log\ (GCFPub_{-1})$ $(29.8^*)\qquad (43.7^*)$	R^2 (bar) =0.98; – (1950-51 to 1990-91)
$Log\ (GDP) = -2.16 + 1.42\ log\ (GCFPub_{-1})$ $(-2.6)\qquad (19.9^*)$	R^2 (bar) =0.98; – (1991-92 to 2003-04)

* significant at one per cent level of confidence.
Note: Parenthetic figures indicate *t* statistics.

It is also found that public sector capital formation has crowded in private investment in the Indian economy. During the period 1971-72 to 2003-04, the public investment elasticity of private investment works out to 1.23. An econometric investigation of determinants of private investment indicates that private investments in manufacturing and services are favourably impacted by public sector investment in the services sector, corroborating the operation of a "crowding-in" phenomenon between appropriate types of public and private investment.[1]

[1] An econometric exercise of real private gross capital formation in manufacturing (*GCFPvtm*) and real private gross capital formation in services (*GCFPvts*) with real bank lending rate (*rl*), real gross domestic product at factor cost (*Y*) and public sector investment in services (*GCFPubs*) (over the period 1970-2000 yielded the following results (RBI, 2002):

$$GCFPvtm = -19{,}261 + 0.61\ \Delta Y(-1) - 811\ rl + 2.2\ GCFPubs \qquad R^2 = 0.76;\ DW = 1.82$$
$$(2.4)\qquad (-2.4)\qquad (4.7)$$
$$GCFPvts = -3{,}889 + 0.22\ \Delta Y(-1) - 304\ rl + 1.41\ GCFPubs \qquad R^2 = 0.84;\ DW = 1.96$$
$$(2.6)\qquad (-2.02)\qquad (6.54)$$

As mentioned above, there is a need to classify the expenditure components in terms of being productive or non-productive in order to ascertain the impact of public expenditure on the growth process. It may be noted that the central government budget categorises expenditures in terms of revenue and capital and Plan and non-Plan groups. With a view to examining the welfare impact, the centre's expenditures need to be classified in terms of developmental and non-developmental categories as done in the states' budgets. An analysis of the last two decades indicates that the share of developmental expenditure in total expenditure has generally declined in respect of centre as well as the states. Furthermore, the states have shared a greater responsibility in undertaking developmental expenditure (Table 3).

In order to examine the growth impulse generated by the developmental expenditure, an econometric exercise on the relationship between gross domestic product at factor cost (GDP) and developmental expenditure (Dev) was undertaken for the period 1980-2004. The results indicate that there is a positive and statistically significant influence of the developmental expenditure on income. The elasticity of the overall income with respect to developmental expenditure works out to about 1.14 during the period 1980-04. Furthermore the responsiveness of income to developmental expenditure has increased during the post-reform period (Exhibit 4). This reflects that with the conducive environment provided by the economic reforms, the developmental expenditures have increasingly facilitated "crowding-in" of private investment thereby facilitating the growth process.

5.2 *Public expenditure and equity*

Another abiding objective of the public expenditure policy in India has been to promote equity through poverty alleviation, employment generation, improving health services, providing education and provision of food subsidies. The impact of

Table 3

Developmental Expenditure of the Centre and States

	1981-91 (Average)	**1992-2004 (Average)**
1	**2**	**3**
Centre's Development Expenditure *(percent of total)*	54.7	46.1
States' Development Expenditure *(percent of total)*	76.5	66.2
Centre's Share in Combined Developmental Expenditure *(percent)*	55.8	51.5

Exhibit 4

GDP and Developmental Expenditure

Equation	Statistics
Log (GDP) = 0.58 + 1.16 log (Dev) *(1.28) (28.3*)*	*R^2 (bar) =0.97; – (1980-81 to 2003-04)*
Log (GDP) = 3.40 + 0.82 log (Dev) *(7.25*) (15.33*)*	*R^2 (bar) =0.96; – (1980-81 to 1990-91)*
Log (GDP) = 0.26 + 1.19 log (Dev) *(0.38) (20.7*)*	*R^2 (bar) =0.97; – (1991-92 to 2003-04)*

* significant at one per cent level of confidence.
Note: Parenthetic figures indicate *t* statistics.

measures undertaken in the above areas is visible in the achievements in respect of various social indicators such as poverty ratio, demographics, education and health. An analysis of the trends of social expenditure of the general government (centre and states combined) indicates that the share of social expenditure in the total general government expenditure rose from 18.9 per cent in 1986-87 to 19.0 per cent during 2003-04 after reaching a peak of 22.2 per cent in 1998-99 (Table 4).

An analysis of the pattern in social expenditure indicates that the share of expenditure on health services in total expenditure on social services declined from 24.1 per cent in 1986-87 to 21.8 per cent in 2003-04. In this context, the lower allocation of expenditures towards health needs to be carefully interpreted in the light of evolving demographic transition in India. The demographic process in India is moving towards a higher share of working age population *vis-à-vis* young and old age dependency (Table 5). As is well known, the economic impact of a decline in dependency ratio is usually beneficial to economic growth, welfare and employment, often referred to as the "demographic dividend" (Mohan, 2004). Thus, India is poised to reap the benefits of this demographic dividend in the next 25 years as also corroborated by the BRIC Report (Goldman Sachs, 2003). Nevertheless, unlike in industrial countries, as India does not have a comprehensive "Beveridgean" social insurance system in place (Heller, 2004), the government's emphasis on social sector expenditures should continue to assume high priority in the foreseeable future.

The share of expenditure on education in total government expenditure on social services declined from 51.4 per cent in 1990-91 to 48.5 per cent in 2003-04. This trend also needs to be carefully interpreted particularly in the light of changing environment where the private sector is being encouraged to take more responsibilities in imparting education. In this set up, the government is increasingly focusing to ensure education for economically weaker sections of the society and also to promote female literacy.

Table 4

Expenditure on Social Services by the Centre and State Governments
(percent of total expenditure)

Years	1986-87	1990-91	1995-96	1998-99	2000-01	2001-02	2002-03	2003-04RE	2004-05BE
1	2	3	4	5	6	7	8	9	10
Centre									
Social Services	3.7	3.1	4.3	5.3	5.6	5.8	5.5	5.2	5.7
Education	1.3	1.2	1.7	2.2	2.1	2.0	2.3	2.3	2.4
Health	0.5	0.5	0.7	0.8	1.0	1.0	1.0	1.0	1.2
Others	1.8	1.4	1.9	2.3	2.5	2.7	2.2	2.0	2.0
States									
Social Services	32.4	32.9	32.6	33.1	32.7	31.0	29.1	25.9	26.8
Education	15.2	17.4	16.5	17.4	17.4	16.1	15.0	12.6	13.3
Health	8.2	7.5	7.3	6.3	7.1	6.6	6.5	5.8	6.2
Others	9.0	8.1	8.8	9.4	8.3	8.3	7.6	7.4	7.3
Combined									
Social Services	18.9	20.3	21.6	22.2	22.1	21.1	20.0	19.0	19.3
Education	8.6	10.4	10.7	11.3	11.3	10.4	10.0	9.1	9.4
Health	4.5	4.5	4.7	4.1	4.7	4.4	4.3	4.2	4.4
Others	5.7	5.4	6.3	6.8	6.2	6.3	5.7	5.7	5.4

Source: As compiled in the Reserve Bank of India from the budgets of central and state governments of India.

The stable share of social expenditure at about one-fifth of the overall government expenditure over the past two decades has facilitated a significant reduction in the incidence of poverty. According to the latest official estimates, the proportion of population living below the poverty line (BPL) declined significantly from 51.3 per cent in 1977-78 to 26.1 per cent in 1999-2000. The Tenth Five Year Plan has set a target of further reduction in the poverty ratio to 19.3 per cent by 2007 and 9.3 per cent by 2012.

The social expenditure of the centre and states, particularly on health, education and poverty alleviation, has direct bearing upon the Human Development Index (HDI) of the country. India ranked 127 in terms of HDI in the year 2002. A cause of concern has been high regional disparity in HDI across the states in India, although an analysis of the state level HDIs by the Planning Commission indicates a decline in such regional disparity during the last two decades. There is a need to enhance the spending on social sector in India to improve its HDI status in general and to achieve the stated objectives of Tenth Five Year Plan of education for all, improvement in health status of the population and “shelter for all” by 2012.

Table 5

Trends in Total Dependency Ratio

Regions/Countries	1950	1975	2000	2025	2050
1	2	3	4	5	6
World	**65.2**	**73.7**	**58.4**	**53.2**	**57.7**
More developed regions	54.4	53.8	48.3	57.0	73.4
Less developed regions	71.0	81.8	61.1	52.5	55.7
Least developed regions	79.7	91.5	86.0	71.4	54.9
Asia	**68.3**	**78.0**	**56.5**	**49.0**	**56.8**
Eastern Asia	62.9	74.1	46.2	47.8	66.0
South-Central Asia	73.4	80.1	65.9	49.5	51.4
South-East Asia	74.4	84.0	58.9	46.7	56.1
Western Asia	75.2	85.3	68.5	59.0	57.1
China	61.3	78.2	46.4	46.2	63.9
India	**73.2**	**77.4**	**62.5**	**46.1**	**52.6**
Bangladesh	70.2	95.4	71.9	50.0	49.0
Sri Lanka	83.7	69.3	48.3	47.8	62.9
Pakistan	76.3	83.0	83.4	64.6	45.9
Indonesia	75.8	80.6	55.2	45.7	57.1
Thailand	83.1	84.4	46.8	44.8	61.9
Malaysia	85.0	84.6	61.9	48.4	54.4
Philippines	89.3	89.7	69.7	46.6	52.0

Note: The total dependency ratio is the number of persons under age 15 years *plus* persons aged 65 years or older per one hundred persons in the category of 15 to 64 years. It is the sum of the youth dependency ratio and the old-age dependency ratio.

Source: United Nations (2002), *World Population Ageing 1950-2050*, Population Division, Department of Economic and Social Affairs.

5.3 Public expenditure and stability

One of the challenges for the government during the reform period has been to strive for the process of fiscal consolidation with public expenditure management as one of the main operating fiscal policy instruments. The challenge has emerged as the public expenditure management had to contend with compression of capital expenditure in the face of committed nature of interest payments, subsidies and defence expenses. As a proportion of GDP, aggregate expenditure of the central government declined almost continuously from 18.5 per cent in 1990-91 to 14.7 per cent in 1996-97 before recovering to 17.1 per cent in 2003-04. It should be noted that the expenditure compression, as part of fiscal consolidation process in the

first half of the Nineties, was mainly effected in the capital outlays which enabled reduction in the fiscal deficit of the centre and states from 9.4 per cent of GDP in 1990-91 to 6.4 per cent in 1996-97.

Although the fiscal corrections achieved in the first half of the Nineties restored macroeconomic stability, it raised concerns about the dwindling capital outlays and its possible repercussions on sustainability of the high economic growth achieved in the mid-Nineties. The need for restoring the capital outlays was felt while simultaneously efforts were made to rationalise functions, activities and structures of most of the Departments and Ministries of the central government so as to curtail wasteful expenditure and suggest measures for optimising government's staff strength. The series of new initiatives undertaken included pre-payment of high cost external debt, buyback of high cost domestic debt and introduction of contributory pensions for new government personnel. These measures enabled some control over expenditure without compromising on capital outlay which was restored in the late Nineties and the early years of the current decade. Notwithstanding an improvement in the expenditure management, fiscal deficit increased to 9.5 per cent of GDP in 2002-03 reflecting the inadequate pace of revenue mobilisation.

Another cause of concern for macroeconomic stability was the worsening fiscal health of the state governments, particularly since the latter half of Nineties. This reflected, *inter alia*, the influence of pay revisions as well as declining transfer of resources from the centre. A series of initiatives to correct this include the medium term fiscal reforms programme, operation of the debt swap scheme to substitute past high cost with new low cost debt and reduction of interest rate on central loans to the states.

It may be noted that fiscal policy may promote macroeconomic stability through the mechanism of an in-built or automatic stabilisers. This is particularly important in the industrial countries as they have provisions like "unemployment dole" which are counter cyclical in nature. In the case on India, the counter cyclical forces in terms of expenditures, typically associated with developed economies, are not prominent. Nevertheless, the expenditures on account of periodic wage revision, drought relief, poverty alleviation measures, and defence if occur in the downswing phase can act as discretionary stabilisers. For instance, the Fifth Pay Commission award during the latter half of the Nineties acted as a source of discretionary stabiliser when industrial output was in the downswing.

6. New dawn in fiscal consolidation

6.1 Developments in 2003-04 to 2004-05

The year 2003-04 was a landmark in terms of fiscal performance of the central government as the fiscal outcome in terms of key deficit indicators showed a marked improvement over the budgeted levels anticipated at the beginning of the year. Apart from higher revenue mobilisation in terms of taxes (particularly

corporate taxes) and disinvestment receipts, one of the major factors was the containment of non-plan expenditure, particularly interest payments. Amidst conducive monetary management and softer interest rate conditions, the interest rates on fresh borrowings declined in recent years. Furthermore, the central government also initiated a strategy of prepaying debt. This facilitated a reduction in the ratio of interest payments to revenue receipts. With a view to pass on the benefits of the softer interest rate regime to the states, they were allowed to swap high cost debt with the low cost fresh loans under the Debt Swap Scheme which was in operation from 2002-03 to 2004-05. There was a reduction of non-plan expenditures in terms of subsidies and grants to the states. Strikingly, a positive development was a decline in the share of non-merit subsidies in total subsidy from 66 per cent in 2002-03 to 58 per cent in 2003-04, thereby reflecting "substantial" improvement in cost recovery from 45 to 47 per cent in the non-merit categories. Social services contributed more to the overall growth of subsidies at 20.5 per cent between 2002-03 and 2003-04 than economic services which grew by 8.0 per cent during the same period (GoI 2004).

Table 6

Fiscal Responsibility and Budget Management Rules 2004

Parameter	Provisions in the FRBM
1	2
Fiscal Deficit (GFD)	GFD to be reduced by 0.3 per cent or more of GDP every year, beginning with the year 2004-05, so that the GFD does not exceed 3 per cent of GDP by end-March 2008
Revenue Deficit (RD)	RD to be reduced by 0.5 per cent or more of GDP at the end of each year, beginning from 2004-05, in order to achieve elimination of the RD by March 31, 2008, as prescribed in the FRBM Act. Subsequently, it was proposed in the Union Budget 2004-05 to move an amendment to eliminate the RD by 2008-09
Contingent Liabilities	The central government shall not give guarantees aggregating an amount exceeding 0.5 per cent of GDP in any financial year beginning 2004-05
Additional Liabilities	Additional liabilities (including external debt at current exchange rate) shall not exceed 9 per cent of GDP for the year 2004-05. In each subsequent year, the limit of 9 per cent of GDP shall be progressively reduced by at least one percentage point of GDP
Borrowings from RBI	Direct Borrowings from the RBI prohibited from the year 2006-07 except by way of WMA to meet temporary mismatches or under exceptional circumstances

The progress in terms of fiscal consolidation, contributed to some extent by reduction in expenditure, paved the way for implementation of the Fiscal Responsibility and Budget Management (FRBM) Act 2003 which was initiated with notification of FRBM Rules, 2004. These rules stipulated the minimum annual reductions of 0.5 percentage point and 0.3 percentage point of GDP, respectively, for revenue deficit and fiscal deficit (Table 6).

Although a front loaded fiscal consolidation was budgeted for the inaugural year with deficit reductions in revenue and fiscal deficits much above the stipulated minimum FRBM thresholds, the fiscal outcome for 2004-05 showed achievement of the FRBM targets though budgeted projections could not be met (Table 7). The slippage in the budgeted targets for 2004-05 was more on account of tax shortfalls and some unforeseen factors and difficulties faced during the course of the year. These include: time taken in the passage of the Finance Bill, the cumulative impact of the post-budget duty concessions given to ease the impact of inflation on the common man, increase in fertilizer subsidy, additional funds allocated for rural telephone network and Tsunami relief.

6.2 *Emerging fiscal policy scenario*

The Union Budget 2005-06 has set a “pause” in the FRBM keeping in view the impact of implementing the recommendations of the Twelfth Finance Commission (TWFC), which implies substantially higher devolution of resources from the centre to the states and some provisions for enabling smoother implementation of Value Added Tax in the states. Nevertheless, the government has

Table 7

Key Fiscal Indicators of the Central Government

(Rupees crore)

Item	2003-04 (Accounts)	2004-05 (BE)	2004-05 (RE)	2005-06 (BE)
1	2	3	4	5
1. Gross Fiscal Deficit	123,272	137,407	139,231	151,144
	(4.5)	(4.4)	(4.5)	(4.3)
2.Revenue Deficit	98,262	76,171	85,165	95,312
	(3.6)	(2.5)	(2.7)	(2.7)
4.Gross Primary Deficit	–816	7,907	13,326	17,199
	(0.0)	(0.3)	(0.4)	(0.5)

BE: Budget Estimates. RE: Revised Estimates.
Note: Figures in parentheses are percentages of GDP.

committed to "resume the process of fiscal correction with effect from 2006-07 and achieve the FRBM goals by 2008-09".

The expenditure management strategy planned for 2005-06 is to switch away from extending loans and towards grants from the centre to the state governments, as recommended by the Twelfth Finance Commission. Accordingly, the non-plan grants to states and UTs are budgeted to increase significantly by Rs.19,125 crore (129 per cent) as against a moderate increase of Rs.1,107 crore (8.1 per cent) in 2004-05. A higher amount of current transfers is aimed at promoting vertical equity of resources (between centre and states).

On the other hand, a noteworthy feature has been a budgeted decline in the expenditure on subsidies to 1.3 per cent of GDP in 2005-06 from 1.5 per cent in 2004-05. The expenditure on food subsidies is expected to decelerate on account of proposed policy to undertake procurement of foodgrains on a decentralised basis, especially in the non-traditional states. This is intended to be more cost effective and would not impair the present MSP-based procurement. As a result, food subsidies are budgeted to decline to 0.7 per cent of GDP from 0.8 per cent in 2004-05. The budget also proposes to reduce the growth in fertilizers subsidies substantially to 3.8 per cent from 32.2 per cent in 2004-05; in terms of GDP, however, it is budgeted to remain at 0.5 per cent. The fertiliser subsidies are expected to be rationalised in future after the Working Group's examination of issues involved in implementing the New Pricing Scheme. With a view to contain and properly target subsidies, a government's Report on Central Government Subsidies in India, prepared by the National Institute of Public Finance recommended in December 2004 recommended a reduction in volume of subsidies relative to revenue receipts, limiting subsidies to only Merit I and II categories while eliminating them from non-merit category products, targeting of subsidies directly to the intended beneficiaries by eliminating input subsidies and focusing more on transfers than subsidies, improving transparency and explicitly reporting subsidies in the budget and avoiding multiple subsidies to serve the same policy objective.

The other components of revenue expenditure, *viz.* interest payments and defence, are, however, budgeted to expand substantially. The substantial rise in interest payments reflects continued dependence on debt resources to finance the government expenditure and additional payments on account of Market Stabilisation Scheme (MSS) reflecting the cost of sterilisation borne by the government. The enhanced defence outlay in the revenue account is due to provisions to meet additional expenditure on pay and allowances and contractual liabilities. The total capital expenditure is budgeted to decline by 43.3 per cent in 2005-06 as against an increase of 9.6 per cent in 2004-05. It may be noted that, the capital outlay is budgeted to rise by 9.8 per cent in 2005-06; however, adjusting for defence expenditure, it would show a higher growth of 20.2 per cent.

The sectoral allocation of expenditure under certain developmental heads indicates the government thrust on rural development through agriculture and universalisation of education. The shares of agriculture and rural development in total expenditure are budgeted to increase in 2005-06 on account of provision made

for developing agriculture market infrastructure, establishment of Rural Knowledge Centre and for initiating strategic agricultural research. The increase in share of health spending reflects higher allocation for financing, *inter alia*, the National Rural Health Mission (NRHM) which will be launched from 2005-06 (Table 8).

There were two major changes in the budgetary practices of the union government during the year 2005-06 which have bearing on the computation of fiscal deficit. The disivestment proceeds, which were earlier treated as non-debt capital receipts, would no longer be a part of the budget. Instead, these proceeds would be credited to an “investment fund”, the income from which will be used to finance expenditure on social infrastructure and to provide capital to viable public sector enterprises.

The second major change is due to the implementation of the recommendations of the Twelfth Finance Commission (TWFC). Accordingly, the share of states in shareable central taxes was enhanced by one percentage point to 30.5 per cent while the loans assistance to the states and Union Territories (UTs) Plan was done away with from 2005-06. However, the Union Budget 2005-06 has made a higher provision of non-Plan grants to the states and UTs. Thus the implementation of the recommendations of TWFC is expected to improve the fiscal position of the state governments and pave the way for cooperative fiscal federalism.

Table 8

Expenditure on Select Developmental Heads

(Rupees crore)

Items	2003-04	2004-05(RE)	2005-06(BE)
1	2	3	4
Agriculture	32900	36614	39727
	(7.0)	(7.2)	(7.7)
Education	10630	12999	15941
	(2.3)	(2.6)	(3.1)
Health	4980	6032	7907
	(1.1)	(1.2)	(1.5)
Rural Development	12138	8525	11359
	(2.6)	(1.7)	(2.2)
Irrigation	370	323	425
	(0.1)	(0.1)	(0.1)

Note: Figures in parentheses are percentages of total expenditure.

6.3 Role of expenditure policy and management in emerging fiscal scenario – An assessment

The fiscal policy strategy in the coming years would be to increase revenues by reaping the opportunity of a high growth phase and at the same time reorienting expenditure to pay for more outlays on education, health and infrastructure. Furthermore, a concerted resolve would be there to improve the quality of implementation and enhance the efficiency and accountability of the delivery mechanism thereby facilitating translation of outlays into outcomes.

First, while the system of providing subsidies would continue to sub-serve the equity objective and remain a measure for protecting poor, the strategy would be to restructure this system cautiously. The food subsidy system which was hitherto a *centralised* system of procuring food grains at remunerative prices and issuing them at reasonable prices is intended to be made more cost effective by decentralising the procurement system especially in the non-traditional states without impairing the system of Minimum Support Prices (MSP). The new pricing scheme which is being worked out for fertilisers and would commence from April 1, 2006 as well as the proposal of replacing FO/LSHS (used as a feedstock) by natural gas are expected to rationalise the fertilizer subsidy bill. The petroleum subsidy is also being rationalised.

The government has announced enhanced outlays for various programmes and schemes for eliminating poverty through generation of gainful employment and accordingly has identified the sectors with high potential. It also seeks to improve health conditions of citizens through better nutrition and hygienic drinking water facilities. The budget 2005-06 bestows special attention to minorities, backward classes and regions and gender specific issues. It intends to provide impetus to rural economy in India in six areas, *viz*., irrigation, roads, water supply, housing, rural electrification and telecom connectivity. It proposes to have a road map for agricultural diversification particularly in respect of fruits, vegetables, flowers, dairies, poultry, fisheries, pulses and oilseeds. It recognises the need for large investment from private and cooperative sectors for setting up agricultural markets, marketing infrastructure and support services. The government has set out a new paradigm in investment policy whereby the government will play essentially a catalytic role in terms of a public private partnership rather than fully funding investment.

The state governments in India have been assigned higher responsibilities by the Constitution (Seventh Schedule, Article 246) in respect of social spending such as health, education and family welfare. The major part of the policy is designed by the Planning Commission and states to undertake the responsibility of implementing these policies. The deterioration in the fiscal health of states has placed pressure on the development and social spending in recent years. It is necessary, therefore, to restore the health of state finances through control of non-developmental expenditure. In this context, the enactment of fiscal rules by five states so far assumes importance in the process of fiscal consolidation at state level. While fiscal

prudence at the state level is important, it should also be recognized that the states in future have to shoulder greater responsibilities of developmental and social spending.

7. Public expenditure policy and management in India – Future perspectives

7.1 Risks to the fiscal consolidation process

While the government has drawn up plans for undertaking effective and efficient economic and social expenditures, the potential risks to the fiscal stability arise on the likely increase in interest payments due to projected significant rise in its market borrowing programme. This may jeopardise the government's plans to phase out revenue deficit by 2008-09. The Kelkar Task Force's strategy of reaching this FRBM target is contingent on freezing of stock of debt at the level that existed at the beginning of the FRBM implementation and softer interest rate conditions which would enable the government to replace old securities as and when they mature with new securities issued at lower interest rates. The substantial increase in market borrowings of the centre budgeted for the year 2005-06 and firming up of interest rate conditions and consequent possibility of rising government's interest expenditures would pose a potential source of risk for reaching the FRBM target of phasing out revenue deficits by 2008-09.

If the committed expenses in the form of interest expenditures mount, this would, perforce, make the government to compromise on other productive expenditures. Specifically, the Kelkar Task Force had projected a growth of 12.8 per cent *per annum* in plan expenditure of the centre and that capital expenditure at least maintains its ratio to total expenditure at 2003-04 level in the baseline scenario (or a steady increase in capital expenditure to reach about 0.5 per cent of GDP higher than the baseline projection by 2008-09). Therefore, the government would be facing a dilemma of whether to stick to its stated outlays so as to pursue its social and economic expenditure goals or compromise on them so as to be on track of achieving FRBM targets by 2008-09.

An analysis of the consolidated fiscal position of the state governments shows a sizeable deterioration in their finances during the Nineties followed by some correction during 2000-01 to 2002-03 enabled by reforms. The worrisome feature is, however, that the underlying weaknesses in the state finances still remain and moreover there was a reversal of fiscal correction during 2003-04 partly on account of one-off factors essentially relating to the settlement of dues of the state Electricity Boards aimed at strengthening the power sector.

7.2 Proposed strategy for future expenditure reforms: emphasis on outcomes, not just outlays

The Kelkar Task force had noted that despite expenses by the central and state governments, the provision of public goods in India lacked quality as well as quantity. It, therefore, recommended a goal of refocusing expenditure on public goods as well as "to improve instrumentalities to translate a resource outflow into public goods *outcomes*". The Task Force also had admitted that while most of the non-Plan expenditures (defence, salaries and pensions) were relatively inflexible, interest payments were an exception with the expectation of declining average interest cost and fiscal consolidation. However, as discussed above, the interest risks posed by higher market borrowings and with the pause in the FRBM implementation in 2005-06, even the leeway of softening of interest expenses are less evident especially when interest rates are on an upward cycle. Therefore, the central theme of fiscal consolidation has to be the improvement in tax-to-GDP ratio, while simultaneously addressing the concern regarding quality of public expenditure in respect of public goods through a four-pronged strategy.

First, a greater share of total expenditure has to be devoted to public goods as against transfers and subsidies. In particular, it must be recognised that the government expenditures on pure public goods (law and order, and defence) can play a key role in the development process as the consumption of these goods by an incremental citizen introduces no costs and one cannot exclude any citizen from benefiting from such consumption. Similarly, some quasi-public goods such as primary health and education services would also qualify as legitimate functions of the government. Simultaneously, as the present system of food and fertilizer subsidy is ineffective in reaching the poor sections, the government's rationalisation so as to appropriately contain and target them assume prime importance. Furthermore, there is a need to review the existing expenditure classifications in India in terms of revenue and capital or plan and non-Plan. The classificatory system should clearly switch to the international norm of *current* and capital expenditures bifurcation as also a breakdown of government expenditure in terms of subsidies and public goods to facilitate a better analysis of the public expenditure management in India.

Second, it must be recognised that local governments are better equipped for provision and upkeep of local public goods (health, primary education, water and sewage, and local roads) as they are more attuned to local tastes and preferences. They can also respond better to local problems and allocate resources as per the local priorities and above all can ensure sound outcomes. Additionally, the political accountability to local voters raises a case for devolution of resources for production of local public goods to local government. The 74th amendment to India's constitution has been made to set up a process of higher transfer of resources earmarked for production of local goods to Panchayati Raj institutions who have better incentive to spend effectively as well as better knowledge about local preferences, local problems and alternative production technologies so as to ensure actual outcomes. A powerful instrument to ensure local delivery of outcomes is to shift resources from the existing centrally-driven programmes to the Panchayati Raj

institutions contingent on sound reform initiatives emerging from these lower levels of government.

Third, the central theme of expenditure reforms is the shift in focus from outlays to outcomes as emphasised in the government of India's Budget 2005-06. Accordingly, a framework needs to be envisioned which documents the targets in each of the expenditure schemes in terms of expected outcomes in numerical terms. The Union Budget 2005-06 has already initiated the process by setting physical targets for various projects. This, therefore, creates an appropriate setting for undertaking a subsequent scheme-wise performance audit to test the actual delivery on the promised goals in terms of outcomes.

Finally, the *provision* of public goods can often be achieved more effectively through private sector operations particularly in the production stage. Thus, the role of public-private partnerships needs to be extended to a wider range of public goods. The government has already taken initiatives in this regard.

There is a need to undertake expenditure reforms so as to not only enhance the productivity but also the quality of public expenditure. Accordingly, there is growing realisation in the government to shift from "itemised" control of expenditure to its "budgetary control". Accurate budgeting at the commencement of the year needs to be followed by delegation of resources to the Ministries for careful operations within the approved budgets, well regulated cash flow, strong financial management systems at all levels and organisational restructuring/reengineering to ensure effective utilisation of resources.

7.3 Growth potential in the years ahead

The stated strategy for fiscal consolidation process in India to achieve the FRBM target is based on higher revenue mobilisation and containment of non-productive expenditures. The achievement of the FRBM targets by 2008-09 implies that combined deficit of the centre and the states will be around six per cent of GDP as compared to more than nine per cent in 2003-04. Once the FRBM targets are achieved, the continuance of efforts towards revenue mobilisation and reduction in non-productive spending would provide room for expansion of developmental spending. As discussed above, each percentage point increase in developmental spending would lead to an increase of about 1.2 per cent in GDP.

8. Concluding observations

This paper has attempted to analyse the role of public expenditure in India as a key operating fiscal policy instrument in order to achieve the goals of growth, equity and stability and yet maintaining the intermediate targets of deficit indicators to ensure the sustainability of public finances. An analytical framework indicates that the various components of government expenditure may be identified to have specific role in the pursuit of fiscal policy goals. The evolving pattern in the public

expenditures in India over the years brings fore the following developments. The overall expenditure has shown an upward movement till the mid-Eighties. The macroeconomic crisis in the early Nineties necessitated fiscal consolidation which primarily came from expenditure compression particularly in the capital outlays whereas increasing interest payments remained on the upward trajectory. As a result, public expenditure witnessed a decline during the first half of the Nineties mainly on account of the central government's expenditure whereas the expenditure of state governments has remained mostly stable in terms GDP. The share of developmental expenditure has declined over the years which needs to be reversed to improve future economic growth potential. The developmental expenditure, particularly in the social sector, has important implications for human development in India.

Though the capital outlays have shrunk in terms of GDP, an encouraging development has been the improvement in the responsiveness of the income generation process to government expenditure in the post reform period. This reflects the conducive environment generated by the liberalisation of regulatory controls on the private sector. The expansion of the private sector resulted into a better utilisation of the public infrastructure accumulated over the years. It is observed that in India, the counter cyclical forces in terms of the expenditures typically associated with developed economies are not prominent. Nevertheless, the expenditures on account of periodic wage revision, drought relief, poverty alleviation measures, and defence, if occur in the downswing phase, can act as discretionary stabilisers.

Public expenditure management remains the main operating fiscal policy instrument in India in achieving the goals of economic growth, equity and stability. Although the implementation of the Fiscal Responsibility and Budget Management (FRBM) Act for the central government in India has set a pause after the first year due to a stress in the union budget arising out of the higher share of tax devolution to the state governments, it is well recognised that the bulk of fiscal adjustment has to be borne out by improving greater mobilisation of revenue receipts rather than curtailing capital expenditure. As expenditure multiplier is higher than the tax multiplier, the expansionary impact of increased capital expenditure will far outweigh the contractionary influence of increased taxes. This has been recognised in the Indian context and with the Indian economy running "nearly at full steam", there is a case of reaping the benefits by higher mobilisation of revenue receipts. This can emanate in three ways. First, when the economy is on an upswing, there is more probability of mobilising more taxes. Second, the increased capital expenditures would promote growth and enable higher tax collections. Thirdly, the user charges levied on the use of capital goods would boost non-tax revenue collections. Furthermore, given the fiscal policy transmission lag, there is a need to front load decisions on public investments, especially at a time when the Indian economy is on a high growth phase and industries have improved their efficiencies and increased their capacity utilisation. The higher tax mobilization as well as recently increased share of their devolution to the states would be able to garner resources for implementation of schemes for provision of local public goods.

The deterioration in the fiscal health of states has placed pressure on the development and social spending in recent years indicating a need for restoring the health of state finances through control of non-developmental expenditure. In this context, the enactment of fiscal rules by five states so far assumes importance in the fiscal consolidation process at the state level. While fiscal prudence at the state level is important, it should also be recognized that the states in future have to shoulder greater responsibilities of developmental and social spending. The implementation of recommendations of the TWFC, in this regard, is expected to provide adequate resources complementing the efforts made by the states to put their finances in order.

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