**Lesson-9**

# PUBLIC DEBT IN INDIA – II

## (LATEST ESTIMATES AND DEFICIT FINANCING ESTIMATES)

### Structure


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## 9.0 OBJECTIVES

After reading this lesson, you shall be able to :

- understand public debt of the Central and State governments of India.
- comment on deficits (concepts) in India.
- explain the extent of deficit financing in India.
- discuss the effects of deficit financing.

## 9.1 INTRODUCTION

The previous lesson discusses the theoretical issues related to Public Debt. With the theoretical base we move ahead in this lesson to understand the Public debt in the federal set up of India – i.e. at Central and State level.

## 9.2 PUBLIC DEBT OF CENTRAL GOVT. BEFORE INDEPENDENCE

The Government of India, like all Governments, has borrowed in the past and does so now. But Union and State Governments are empowered to borrow under certain conditions and within certain limits. In the British days, the Government borrowed mainly for was purposes. But a large part of Indian public debt was productive as it was incurred to meet such capital expenditures as railway construction, irrigation works, etc. In 1939, the total Indian public debt stood at over Rs. 1,200 crores out of which nearly Rs. 925 crores of debt was covered by interest-yielding assets and other securities and the

balance was uncovered or unproductive. Of the total public debt, about Rs. 730 crores represented internal debt, and about Rs. 470 crores represented India's external debt of India's sterling debt.

During the Second World War, the Indian Government was able to pay off its commitments in England. India's sterling debt was paid off and, in fact, India accumulated sterling balances. Through favourable trade balances, through sale of silver in London and through making purchases of raw materials and food-stuffs in India on behalf of the British Government, India accumulated sterling balances equivalent to Rs. 2,300 crores by 1945-46. A part of these sterling assets was utilized by the Government of India to pay off its sterling debt in London.

During World War II the total rupee debt increased from Rs. 730 crores to Rs. 1,940 crores – an increase of Rs. 1,210 crores. The increase in public debt was due to war expenditure, including capital expenditure on defence and the creation of rupee counterparts for the repatriated sterling debt. The Government was able to borrow a large part of these loans at low rates of interest – about 3 per cent.

## 9.3 INDIAN PUBLIC DEBT SINCE 1951 (CENTRAL GOVT.)

Vigorous efforts were made to achieve the target and Government could nearly get the targeted amounts in all the Plans. Borrowing from the market and mobilizing small savings from the people were used since 1951 as a method of financing economic development in India. The Planning Commission liked ambitious targets to raise large funds from the market and through small savings schemes. This was how public borrowing and public debt came to be used to finance development. Public debt is the total liabilities of the central govt contracted against Consolidated Fund of India. It excludes liabilities contracted against Public Account. Thus, the basic reason for expansion of public debt was the need for raising funds for rapid economic development. In recent years, however, the Government is borrowing to meet its current expenditure. Table 1 explains the size of public debt in India. In 2017-18 public debt stood at 69 lakh crores (64 lac cr internal and 4.8 lac cr external debt)plus 9 lac cr other liabilities.

**Table 1 : Public Debt and other Liabilities of the Central Government**

*(Rs. crores)*

| As at the end of | 1950-51 | 2002-03 | 2010-11 | 2015-16 |
|---|---|---|---|---|
| **A. Public Debt** | **2,054** | **10,80,300** | **26,67,115** | **55,03,676** |
| (a) Internal | 2,022 | 10,20,690 | 26,67,115 | 52,98,217 |
| (b) External | 32 | 59,610 | 1,57,639 | 2,05,459 |
| **B. Other Liabilities*** | **511** | **4,78,600** | **11,14,020** | **13,91,315** |
| **Total Public Debt & other liabilities** | **2,565 (28.5)** | **15,58,900** | **39,38,474 (50.5)** | **68,94,991 (47.4)** |

**Note:** 1.*Excludes Rs. 300 crores which is the amount due from Pakistan on account of its share of pre-partition debt.2.Figures in parentheses show as percentage of GDP.

**Source :** Dutt & Sundaram, 2010, Economic Survey (2016-2017).& jan 2020 www.india.budget.gov.in

As discussed in the previous lesson, the public debt of the Government of India is composed of (a) internal debt(further classified into marketable (i.e issued through market) and non-marketable ( i.e treasury bills issued to state govts) securities and (b) external debt, as explained below :

***Internal debt*** comprises of market loans, compensation bonds, prize bonds and 15-year annuity certificates. It also includes borrowings of a temporary nature, viz., treasury bills issued to the

RBI, commercial banks, etc. and also non-negotiable, non-interest bearing securities issued to international financial institutions like the IMF, World Bank and the Asian Development Bank (A.D.B.).

***External debt*** figures represent borrowings by Central Government from external sources and are based upon historical rates of exchange.

Table 2 summarizes India's public debt position since 1950-51. Four significant points may be noted as regards the public debt of India.

(i) Initially, the Central Government borrowed mainly for *financing development* schemes. What is really alarming now is that the Central Government is forced to borrow even to meet its current revenue expenditure. In other words, the Government has been living beyond its means.

(ii) *External debt* had increased from 1.0 per cent of the *total debt and other liabilities* of the Central Government in 1950-51 to 3 per cent in 2010. The increase in the share of external debt is explained by the rapid rate at which external assistance had been obtained and utilised in recent years. By far the largest share of India's external debt is provided by the United States of America and dollar loans constitute over 30 per cent of India's external debt.

Table 1 shows how the public debt of the Government of India had increased from Rs. 2,054 crores in 1950-51 to Rs. 10,80,300 crores in 2002-03 and to Rs. 28,93,799 crores in 2010-11 and 64 lakh crores in 2017-18.

(iii) In addition to the public debt, the Government of India has *certain other liabilities* for instance, the Government owes to the general public for funds raised through small savings schemes, provident funds, deposits under the Compulsory Deposit Schemes, Income Tax Annuity Deposit Schemes, Reserve Funds of the Railways and Posts and Telegraphs etc. All these constitute the "other" liabilities of the Central Government.

The Government has to pay interest on its other liabilities – often quite high as in the case of public provident fund. The Central Government's other liabilities have also been increasing fast in recent years, as for example :

These increased from Rs. 511 crores in 1950-51 to Rs. 4,78,600 crores in 2002-03 and to Rs. 10,00,832 crores in 2009-10 and 9.15 lac crores in 2017-18..

The total public debt and other liabilities of the Indian Government had come to Rs. 34,95,152 crores by end March 2010; it was only Rs. 2,30,000 crores in March 1989 – *in just 21 years,* Central Government's public debt and other liabilities had increased by nearly 15 times. The annual compound rate of growth of public debt between 1989 and 2009 works out to be 9.8 per cent. In 2017-18 it had been 78 lakh cores.

(iv) The outstanding liabilities of the Central Government, comprising internal and external liabilities, as a proportion of GDP were 55 per cent in 1990-91. It showed a declining trend till 1998-99 when it touched 51 per cent. Since then, they have started rising – as for instance, 58 per cent in 2001-02 and around 60 per cent in 2009-10.

The increasing trend in internal liabilities is a matter of serious concern. This has not only raised the interest burden but also raised concerns about the sustainability of the growing internal debt. At present, net borrowings from the market finances 70 per cent of the gross fiscal deficit.

(v) The burden of servicing of public debt and other liabilities is becoming heavier with every passing year. Interest payment of the Centre was Rs. 90,250 crores in 1999-2000 and is likely to touch Rs. 2,25,511 crores in 2009-10.

According to an agreement concluded in December 1947, all the public debt of undivided India was taken over by the Indian Government. Pakistan was allotted a share, estimated at Rs. 300 crores

but it was permitted to return the amount in 50 equal instalments starting from 1952. Pakistan has not returned even one instalment of its share of public debt. Considering the political relations between the two countries, there is no chance of India receiving Pakistan's share of undivided public debt. However, for certain reasons, this amount is always included as part of the total liabilities of the Government of India; it would be better if it is written off.

## 9.4 DEBT POSITION OF THE STATES

Earlier, the total debt of the States was classified into public debt and unfunded debt. This classification has now been given up and in the new classification, the major heads of debt are :

***(i) Internal Debt :*** This comprises (a) current market loans and bonds issued in connection with the zamindari abolition, (b) ways and means advances and overheads repayable within seven days from the RBI, and (c) loans from banks, other institutions such as loans from State Bank of India, and other commercial banks, National Credit (Long-term Operations) Fund of NABARD, Employees' States Insurance Corporation etc.

***(ii) Loans and advances from the Central Government :*** These comprise loans and advances from the Central Government for Plan and non-Plan purposes.

***(iii) Provident Funds, etc.*** These include State provident funds, Insurance and Pension Fund, Trusts and Endowments, etc.

(i) In a matter of four decades, total debt of the States has risen from about Rs. 2,740 crores in end-March 1961 to over Rs. 16,36,403 crores in end-March 2010. The aggregate public debt of State Governments as ratio of GDP is now around 28 per cent. The increasing trend in state debt-GDP ratio has been significant since 1997.

**Table 2 : Debt Position of the States**

***(Rs. crores)***

| Items | As at the end of March | | | |
|---|---|---|---|---|
| | 1961 | 1971 | 2008 | 2010 (BE) |
| 1. Internal Debt. | 590 | 1,850 | 181623 | 10,64,965 |
| 2. Loans and Advances from the Central Government | 2,020 | 6,360 | 238655 | 1,56,311 |
| 3. Provident fund and other liabilities | 90 | 540 | 173869 | 4,15,127 |
| 4. **Total liabilities (1+2+3)** | **2,740** | **8,750** | **579147** | **16,36,403** |

**Source :** RBI, Handbook of Statistics on Indian Economy 2008-09 and RBI Bulletin, June 2009. c.f. Dutt & Sundaram, 2011; and State Finances **:** A Study of Budgets 2009-10.

From Table 2, the following observations can be made :

(ii) Internal debt of States was around 22 per cent of all states' total liabilities in the 1960s. It has grown, however, over the years, and was around 65 per cent in 2009-10.

(iii) The share of Central loans and advances in the total debt of State Governments has been steadily declining – from about 74 per cent in 1961 to 9.6 per cent in 2010. The heavy indebtedness of States to the Centre was due to such diverse factors as block loans for State development plans, special accommodation, clearing overdrafts of States with RBI, etc.

(iv) State Governments were gradually shifting towards higher-cost sources. The interest burden (i.e. ratio of interest payments to revenue receipts) of States had steadily risen from about 15 per cent during 1960-61 to about 30 per cent during the 2009-10 (budget).

(v) Ways and means advances from RBI which include normal and special ways and means advances and overdraft from RBI repayable within seven working days frequently assumed serious proportions. Often State Governments request the Central Government to convert their overdrafts into loans.

### 9.4.1 The Crisis of State Public Debt : Reasons

In the last few years, heavy public debt and large interest payments have crippled many states which are unable to undertake socially necessary expenditure. The states have the responsibility to maintain law and order, build and maintain infrastructure, provide health and sanitation, education and other essential services. Many states are unable to incur these necessary types of public expenditure. Many others are in a serious financial crisis and are literally limping along.

On the one hand, public debt is mounting and on the other, states have been forced to pay high rates of interest. There are many reasons for this sad state of affairs. Till 1997-98, the fiscal deficit of the States as a proportion of GDP was around 3 per cent and was under control. Since then, states were forced to run into huge fiscal deficits essentially because of rise in revenue deficits – state expenditure on salaries and pensions sky-rocketed directly due to Central Government measures arising out of the salary hikes on the basis of recommendations of the Fifth Pay Commission.

Secondly, the Centre has been directly responsible for the high interest rates of States public debt. Under the Indian Constitution, the Centre has the power to determine both the extent and the terms of borrowings by States from all sources, including the Centre itself. This power has been used/abused by the Centre against the states for the last many decades in various ways. One way is that the Centre charges high rates of interest on debt which it issues to the states – in fact, invariably the rate of interest for the states is higher than the rate at which the Centre itself has been paying.

Further, when State Governments raise debt provided by multi-national institutions like World Bank and ADB, they are charged a higher rate by the Central Government which is the intermediary – than the rate of interest charged by the international institutions.

Again, the Central Government has abused its constitutional powers to limit the ability of States to borrow from the market and from commercial banks and financial institutions.

Finally, State Governments which have a revenue deficit have to seek special permission from the RBI to borrow from commercial banks.

The result of these factors is that the average rate of interest which the States have to pay on their debt has remained relatively high – around 10 to 11 percent. At the same time, the average rate of interest paid by the Centre on its own debt has come down from about 9 percent to 6.5 percent. In other words, the Centre has always played the usurious moneylender to the States.

In the past, Finance Commissions have recommended schemes to reduce the volume of Central Governments loans to the States.

The growing debt burden of the States has been a source of serious concern for the States and the Centre. With the active help of the Government of India, a Debt Swap Scheme was been formulated to liquidate high cost loans given by the Government of India to the States. The States have agreed to utilise 20 per cent of net small savings proceeds released from September 2002 to pre-pay high cost Government of India loans and advances.

The Twelfth Finance Commission recommended a scheme of Debt Relief for the period 2005-10. The scheme envisages the rescheduling of all Central loans contracted till end-March 2004 and outstanding as on end-March 2005 into fresh loans for 20 years carrying 7.5 per cent interest. This provision is conditional to a State enacting the Fiscal Responsibility Legislation.The implication are : (a) the States are irresponsible in their expenditure, (b) they do not mobilize resources themselves and (c) they themselves are responsible for their mounting public debt. Net borrowing ceilings of the States has been fixed at Rs 6,11,186 crore limiting the fiscal deficit target of 3 pc of respective state GSDP as recommended by 14$^{th}$ Finance commission with a maximum of 0.5 pc above 3 pc.

The Union Government is in a position to raise loans at slightly more favourable terms than the States. It is able to offer a lower rate for loans of longer maturity than the States. Further, there is a slight disparity in the terms at which different States can borrow. It has been suggested that the Union Government alone should raise loans from the market and should distribute the proceeds among the States according to their requirements.

Since Independence, the Central Government has set up a series of banking and financial institutions which indeed constitute a captive market for Government loans. We mean here the nationalised banks, statutory and public provident funds, LIC, GIC etc. this captive market is forced to absorb the huge amount of loans raised by the Centre.

## 9.5 MEASUREMENT AND SIZE OF DEFICIT IN INDIA

At the outset, let us have a clear idea of different kinds of deficits and financing of these deficits.

### (A) Revenue Deficit (RD)

Since 1950-51 the Government of India recognised only two types of deficits, viz., revenue deficit and overall budgetary deficit.

**Revenue Deficit = Revenue Receipts – Revenue Expenditure.**

The concept of revenue deficit is a simple and straight one. Current revenue expenditure of the Central Government is composed of Plan and non-Plan expenditure of the Government, and is met out of current revenue receipts (which include net tax revenue and non-tax revenue of the Central Government). In Table 21, we have calculated that, in 1990-91 :

Total revenue receipts = Rs. 54,950 crores

Total Revenue Expenditure = Rs. 73,510 crores

Revenue deficit = Revenue Receipts – Revenue Expenditure

= Rs. 54,950 crores – Rs. 73,510 crores

= Rs. –18,560 crores.

Let us calculate revenue deficit for the year 2010-11 :

Revenue Receipts of 2010-11 : Rs. 6,82,212 crores

Revenue Expenditure of 2010-11 : Rs. 9,58,724 crores

Revenue deficit for 2010-11 = 6,82,212 – 9,58,724 = Rs. – 2,76,512 crores.

Revenue deficit (deficit is indicated by minus symbol) reflects the failure of the Government of India to meet its current expenditure from its current revenues.

Till the middle of the 1970's, the revenue receipts of the Central Government exceeded its

revenue expenditure; accordingly, the Central Government enjoyed revenue surplus. Actually, on the recommendations of the Taxation Enquiry Commission (V. T Krishnamachari Commission), the Government of India had adopted, at the time of the First Plan, a ***deliberate budgetary policy of revenue surplus*** which meant, creating excess of current receipts over current expenditure. This revenue surplus was to be achieved through deepening and widening of the tax base and thus increasing tax revenue on the one side and strict control of revenue expenditure on the other (in other words, keeping the public expenditure under check). This surplus revenue was to be used to finance economic development under the Five Year Plans. Surplus budgeting was a laudable objective.

In a period of about two decades or so (1951-75), however, the objective of revenue surplus was gradually eroded because of ***continuous expansion of current expenditure,*** particularly of the e.

**Table 3 : Calculation of Fiscal and other Deficits**

***(Rs. crores)***

| | | 1990-91 Actual | 2010-11 (Budget) |
|---|---|---|---|
| 1. | Revenue Receipts | **54,950** | **6,82,212** |
| 2. | Capital Receipts | **39,010** | **4,26,535** |
| | of which | | |
| | (a) Loan recoveries and other receipts | 5,710 | 45,129 |
| | (b) Borrowings and other liabilities | 33,300 | 3,81,408 |
| 3. | Total Receipts (1+2) | **93,960** | **11,08,749** |
| 4. | Revenue Expenditure | **73,510** | **9,58,724** |
| 5. | Capital Expenditure | **31,800** | **1,50,025** |
| 6. | Total Expenditure | **1,05,310** | **11,08,749** |
| 7. | *Revenue Deficit* (1-4) | 18,560 | 2,76,512 |
| *8.* | *Budgetary Deficit (3-6)* | 11,350 | NIL |
| *9.* | Fiscal Deficit {6-(1+2(a) or 2(b) | **44,650** | **3,81,408** |

**Note :** Budget figures are rounded. **Source *: Budget at a Glance***, 2010-2011 c.f. Dutt & Sundaram, 2011.

non-Plan category i.e., general administration, defence, interest payments and major and minor subsidies. This was, in spite of the enormous increase in tax receipts during the period. Accordingly, revenue deficit became a special feature of Central Government budgeting from the middle of the 1970s.

**(B) Budget Deficit (BD)**

Budget Deficit = Total Receipts – Total Expenditure

Here total receipts include total revenue receipts and total capital receipts. In the same way, total expenditure is the addition of total current expenditure and total capital expenditure (or disbursements). In table 3, mentioned that in the year 1990-91 :

Total Receipts = Rs. 93,960

Total Expenditure = Rs. 105,310

Budget Deficit = (-) 11,350

For the year 2010-11, Dutt & Sunderam have calculated as follows :

Budget Deficit = Total Receipts (Rs. 11,08,749 cr) - Total Expenditure (Rs.11,08,749 crores)

= Nil

Budget deficit, sometimes also referred to as overall budget deficit, occurs when total expenditure exceeds total receipts, this was called deficit financing by the ministry of finance. The Central Government met its over all budget deficit by net of Treasury bills to the RBI, This led to printing of additional currency by RBI against Governments IOU, RBI gave the Government its IOU, namely, its currency notes.

The whole concept of budget deficit or over-all budget deficit since 1950-51 and the method of covering it by borrowing from RBI through the sale of Treasury Bills was wrong. The basic mistake was the calculation of "Capital receipts" by the Finance Ministry of the Government of India. According to the Finance Ministry, capital receipts are the sum of

(a) Recoveries of loans,

(b) other receipts, and

(c) borrowings and other liabilities

Really speaking, the third source i.e. borrowing and other liabilities – are not receipts of the Government and should not be included under capital receipts. They are the liabilities of the Government, payable to the public. In other words, they also form part of the over-all budget deficit.

Accordingly the traditional concept of budget deficit financing was restrictive and it could just indicate only the extent of monetary deficit. B.R. Shenoy was the first economist to point out, as far back as 1954-55, ***the dangerous implications of regarding market borrowings and other capital receipts as part of Government receipts*** and taking only over-all budget deficit as deficit financing. The actual extent of deficit financing in any given year should include.

(a) over-all budgetary deficit, *plus*

(b) market borrowings, small savings collections and other capital receipts which are actually liabilities.

B.R. Shenoy's warning was brushed aside by other economists and by the Government of India for a long time. It was finally left to the Sukhmoy Chakravarty Committee on the Working of the Monetary System in India to point out the inherent weakness of the definition of the budgetary deficit as deficit financing and the necessity to change the concept. The real deficit of the fiscal operations, the Committee mphasized, should ***include not only budgetary deficit but also market borrowings and other liabilities.*** The Government of India accepted this recommendation of Sukhmoy Chakravarty Committee, (a) gave up the conventional concept of deficit financing and (b) started the calculation of a third concept of deficit, known as fiscal deficit from the year 1997-98.

### (C) Fiscal Deficit (FD)

In simple terms, *fiscal deficit is budgetary deficit plus market borrowings and other liabilities of the Government of India.* In more clear terms,

**Fiscal deficit = Revenue Receipts+ Capital receipts (only recoveries of loans and other receipts)**

— **Total expenditure**

OR

= Budget deficit + Government's market borrowings and liabilities.

Let us illustrate the calculation of fiscal debt for the year 2010-11

**Calculation of Fiscal deficit for the year 2010-11:**

**Fiscal deficit =** Total expenditure for 2010-11, i.e.

Rs. 1020838 crores – Total Receipts (Revenue Receipts (Rs. 6,82,212 crores)

+ Recoveries of loans and other receipts) (Rs. 45,129 crores) i.e. Rs. 7,27,341 crores

= 3,81,408 crores.

OR **Fiscal deficit =** Budget deficit (Nil)+ Market Borrowings and liabilities (Rs. 3,81,408 cr)

Fiscal deficit thus indicates ***the total borrowing requirements of the Government from all sources***. From the point of view of the economy, fiscal deficit is the most significant, since ***it shows the gap between Government receipts and Government expenditure.*** It reflects the ***true extent of borrowing*** by the Government in a fiscal year. On the other hand, the conventional concept of budgetary deficit reflects only the Government's borrowing from RBI.

**(D) Primary Deficit**

In recent years the Finance Ministry has introduced one more concept of deficit known as "primary deficit" which does not have any policy significance.

**Primary deficit = Fiscal deficit – Interest payments**

In 2010-2011 budget, fiscal deficit was put at Rs. 3,81,408 crores and interest payments at Rs. 2,43,664 crores.

Accordingly Primary deficit during 2010-11

= Rs. 3,81,408 crores – 2,48,664 crores

= Rs. 1,32,744 crores.

## 9.5.1 Deficit Trends in Recent Years

Debt –to-GDP ratio measures relationship between government debt and the Gross Domestic Product**.** First lets discuss deficit trends for India in recent years.

(a) Revenue deficit has been rising quite fast – from Rs. 18,560 crores to Rs. 2,76,512 crores between 1991 and 2011. As percentage of GDP, revenue deficit had ranged between 3.5 to 4.7 per cent which was regarded as quite high. Such huge revenue deficit indicated clearly that the Government had been living beyond its means and that it had to cut its current expenditure – specially its non-plan expenditure – instead of looking for sources of additional taxation. In the last four years of the decade2001-11 revenue deficit had declined to 1.5 per cent of GDP,in 2018-19 it rose to 2.2 percent of GDP.

(b)Originally, budget deficit was calculated to show RBI lending to the Government. Since 1997

RBI lending to Government through ***ad hoc*** Treasury Bills was given up. The concept of budget deficit has lost its relevance.

(c) The Government has discontinued the issue of ***adhoc treasury bills to RBI,*** but instead, it will tap 91 days treasury bills from the market. This would be ***part of the capital receipts*** under the heading “borrowing and other liabilities.”

(d) Fiscal deficit grew rapidly and dangerously in late 1980s – from Rs. 27,040 crores in 1988-89 to Rs. 44,630 crores in 1990-91.The international financial institutions such as the World Bank and the IMF objected to the high rate of fiscal deficit (7.7% of GDP) in 1990-91 and asked the Government of India to reduce it over the next few years. Accordingly, the Government reduced fiscal deficit as a percentage of GDP to 5.9 and 5.7 per cent in 1991-92 and 1992-93 respectively. During 1993-94, however, fiscal deficit rose to 7.4 per cent of GDP and reduced in post reforms period and it was Rs. 4,00,996 crores in 2007-08. It is put under check by FRBM Act 2003(amended in 2012).In the year. 2015-16 it was 3.9 pc of GDP,3.5pc in 2017-18 and (Rs 9,31,725 cr i.e.) 3.4 pc of GDP in 2019-20 while target was 3.3 pc of GDP due to slow GDP growth of 5.8 pc..

**Table 4a : Central Govts Deficit Trends in India** **(in ` cr and in parentheses *as percent of GDP)***

| Year | Revenue deficit | Fiscal deficit | Primary deficit |
|---|---|---|---|
| 1990-91 | 18,560<br>(3.2) | 44,630<br>(7.7) | 23,130<br>(4.0) |
| 2006-07 | 80,22<br>(1.9) | 1,42,570<br>(3.5) | –7,700<br>(0.2) |
| 2007-08 | 52,569<br>(1.1) | 1,26,912<br>(2.5) | –44,118<br>(–0.9) |
| 2008-09 | 53,439<br>(4.5) | 3,36,992<br>(6.0) | 1,44,788<br>(3.2) |
| 2015-16 | 4,01,775<br>(2.8) | 5,32,381<br>(3.9) | 2,57,161<br>(0.7) |

**Note :** Figures in brackets are estimated percentages of GDP.
**Source :** Economic Survey, 2007-08, and recent issues; *Budget at a Glance, 2010-11,cf* Dutt & Sundaram.

For many years, the Finance Ministers of the Government of India were not worried, as they could raise funds from the market, from the captive banks and other financial institutions. The RBI, however, has been warning the Government regularly of the impending debt trap. It was only when the World Bank and International institutions refused to bail out India in 1990-91 unless it reduced its fiscal deficit, that the Government was forced to take stringent measures to control non-plan expenditure.

**Table 4b: Central Govts Deficit Trends in India**

***(as percent of GDP)***

| Year | Revenue deficit | Primary deficit | Fiscal deficit |
|---|---|---|---|
| 2009-10 | 5.2 | 3.2 | 6.5 |
| 2010-11 | 3.2 | 1.8 | 4.8 |
| 2011-12 | 4.5 | 2.8 | 5.9 |
| 2012-13 | 3.7 | 1.8 | 4.9 |
| 2013-14 | 3.2 | 1.1 | 4.5 |
| 2014-15 | 2.9 | 0.9 | 4.1 |
| 2015-16 | 2.5 | 0.7 | 3.9 |
| 2017-18 | 2.2 | 0.2 | 3.4 |

**Source :** Lekhi, 2019, Economic Survey, 2016-2017 and 2019-20,p 38 & 39

The uncontrolled growth of revenue deficit is due to the sharp rise in non-plan expenditure, mainly on account of higher interest payments, rise in major subsidies and increase in pensions payments. It was the NDA Government that made a two-pronged attack in reducing revenue and fiscal deficits through augmenting revenue on the one side and controlling non-plan expenditure on the other. According to 2008-09, fiscal deficit turned out to be 6.0 per cent of GDP. For Budget 2010-11, Fiscal Deficit has been 5.5 percent of GDP and 3.3 percent in 2018-19. .

As shown in Table 4 b, the Revenue Deficit has been declining since 2009-10 and had been around 3.7pc,3.2 pc and 2.9 pc of GDP in 2012-13, 2013-14 and 2014-15 respectively. In 2017-18, it was 2.6 pc of GDP.

The Primary Deficit was .8 pc (2012-13), 1.1 pc (2013-14) and 0.1 pc (2014-15) of GDP. The Fiscal Deficit was 4.9 pc(2012-13), 4.5 pc (2013-14) and 4 pc (2014-15) and 3.5 pc(2017-18) of GDP respectively.

**Self Assessment Question**

Q. 1 Define Fiscal Deficit, Revenue Deficit and Primary Deficit. Give latest estimates..

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The fashion of legal restraints on government fiscal behaviour was set by the United States, where in the mid-1980s the Balanced Budget and Emerging Deficit Control Act (Gramm-Rudman-Hollings Act) required a steady decline in the federal government's deficit to zero within a stipulated and fairly short timeframe. Such a legal binding on government in fiscal matters is extreme by any standard. Nevertheless, besides the USA, some other countries have opted for such an extreme measure and a few other countries preferred to pursue balanced budget policies without legal stipulation. India opted for the legal course in 2000 after having failed to restore fiscal balance for about a decade.

## 9.6 THE FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT (FRBM) ACT

The Committee on Fiscal Responsibility Legislation was constituted on January 17, 2000 to look into various aspects of fiscal system and recommend a draft legislation on fiscal responsibility of the government. It was announced in the Budget for 2000-01 that the government intended to create a strong institutional mechanism embodied in Fiscal Responsibility Act to restore fiscal discipline at the level of the Central government. Accordingly, the Fiscal Responsibility and Budget Management (FRBM) Bill 2000 was introduced in Lok Sabha in December 2000.

The FRBM Bill attempted to fix up responsibility on the government to strengthen the framework for adopting a prudent fiscal policy and paves the way for accomplishing macroeconomic stability.

**Original Bill of objectives**

The original Bill in operational terms has aimed at the following :

**1. Revenue deficit.** Reducing revenue deficit by an amount equivalent to 0.5 per cent or more of the GDP at the end of each financial year, beginning on April 1, 2001. The revenue deficit thus should be reduced to nil within a period of five years ending on March 31, 2006. Once revenue deficit becomes zero, the Central government should build up surplus amount of revenue which it may utilise for discharging liabilities in excess of assets.

**2. Fiscal deficit.** Reducing gross fiscal deficit by an amount equivalent to 0.5 per cent or more of the GDP at the end of each financial year beginning on April 1, 2001. The Central government should thus bring down gross fiscal deficit to less than 2 per cent of the GDP for that year, within a period of five years ending on March 31, 2006.

**3. Public debt.** Ensuring that within a period of 10 financial years beginning from April 1, 2001 and ending on March 31, 2011, the total liabilities (including external debt) of the Central government at the end of a financial year do not exceed 50 per cent of the GDP for that year.

**4. Borrowing from the RBI.** The Central government shall not borrow normally from the RBI. However, the Central government may borrow from the RBI by way of advances to meet temporary excess of cash disbursement over cash receipts during any financial year in accordance with the agreements which may be entered into by the government with the RBI.

### 9.6.1 Provisions of the FRBM Act

The FRBM Bill denied freedom to future governments in respect of fiscal management and few such recommendations were diluted. The diluted version of the original Fiscal Responsibility and Budget Management Bill was passed by the UPA government immediately after assuming power in July 2004. The rules made under FRBM Act specify the annual targets for reduction of fiscal and revenue deficits. The rules also prescribe the formats for medium term fiscal policy statement, the fiscal policy strategy statement and the macroeconomic framework statement to be presented to Parliament along with the annual financial statement.

*The FRBM Act which became effective from July 5, 2004 mandates the Central Government to eliminate revenue deficit by March 2009 and subsequently build up a revenue surplus. The Act also mandates the Central government to reduce fiscal deficit to an amount equivalent to 3 per cent of GDP by March 2009.*

### Box : FRBM Approach and Fiscal Deficit in 2009-10 and 2010-11

**Central Government's Fiscal Imbalance**

- Revenue deficit - 5.2 per cent of GDP in 2009-10 and 3.4 per cent of GDP in 2010-11.
- Gross fiscal deficit - 6.4 per cent of GDP in 2009-10 and 5.1 per cent of GDP in 2010-11.
- Primary deficit - 3.1 per cent of GDP in 2009-10 and 2.0 per cent of GDP in 2010-11.
- Revenue expenditure - 13.9 per cent of GDP in 2009-10.
- Capital expenditure - 1.7 per cent of GDP in 2009-10.
- Interest payments - 3.2 per cent of GDP in 2009-10.
- Major subsidies - 1.9 per cent of GDP in 2009-10.
- Defence expenditure - 1.4 per cent of GDP in 2009-10.

**Central and State Governments' Combined Fiscal Imbalance**

- Revenue deficit - 4.1 per cent of GDP in 2008-09.
- Gross fiscal deficit - 8.5 per cent of GDP in 2008-09.

**FRBM Approach**

Neo-classical ideology emphasises balanced budget approach.

For restoring fiscal soundness - The Central government introduced FRBM Bill in Lok Sabha in 2000: FRBM Act passed in 2004. FRBM Act anti-democratic.

FRBM Act mandates for the Central government:

1. Revenue deficit to fall to zero by 2009
2. Fiscal deficit to be reduced to 3 per cent of GDP by March 2009.

Be cause of slowdown in the economy since the latter half of the financial year 2008-09, these deadlines laid down in the FRBM Act were postponed.

**Source :** Misra & Puri, 2011

- **. Assumptions of the FRBM legislation.**

The FRBM legislation is based on the following assumptions. (c.f. Misra & Puri, 2011)

(i) Lower fiscal deficits lead to higher and more sustained growth.

(ii) Large fiscal deficits necessarily lead to higher inflation.

(iii) Large fiscal deficit increases external vulnerability of the economy.

Because of slowdown in the economy during the second half of the financial year 2008-09, tax collections in this year fell. At the same time, the government was obliged to undertake massive expenditure programmes to raise demand to boost the economy. As a result, target deadlines under the FRBM Act have been ignored. In fact, fiscal deficit in 2008-09 was as high as 6.0 per cent of GDP which rose further to 6.4 per cent of GDP in 2009-10. This is the position when 'oil bonds' issued to oil-marketing companies and 'fertiliser bonds' issued to fertiliser companies are not included in the calculation of fiscal deficit. If these 'off-budget liabilities' are also included, figure for fiscal deficit would be much higher. For example, the Prime Minister's Economic Advisory Council reported in end-July 2008 that "total off budget liabilities of the Centre could exceed 5 per cent of GDP". This is over and

above the Central fiscal deficit of 6 per cent of GDP in 2008-09. Accordingly, the 'true' fiscal deficit of the Centre in 2008-09 probably exceeded 10 per cent of GDP.

If the fiscal deficits of the States are also considered, the true challenge of fiscal consolidation in the coming years can be easily imagined. According to Shankar Acharya, "In some ways, the task ahead is harder because it may be unreasonable to expect the kind of revenue buoyancy experienced in recent years".

. Among the emerging economies, India had one of the largest fiscal expansions of the order of about 10 per cent of the GDP in both 2009 and 2010.The FRBM Act provides for greater transparency in fiscal operations, quarterly review of fiscal situation and regulating direct borrowing from the RBI in a bid to check borrowing and control expenditure to effect fiscal discipline. The original version of the FRBM Bill had prohibited direct borrowing from the RBI after three years of the passage of the bill except to meet temporary needs. The present FRBM legislation has done away with this provision.

The FRBM legislation has now made it mandatory for the Finance Minister to make an annual statement to Parliament on the fiscal situation besides explaining any deviation in meeting the fiscal obligations cast on the Centre. The legislation provides for responsibility of the Central government to ensure inter-generational equity in financial management and long term macroeconomic stability by achieving sufficient revenue surplus.

**9.6.2 Amendments to FRBM Act**

Through Finance Act 2012, amendments were made to the Fiscal Responsibility and Budget Management Act, 2003 through which it was decided that in addition to the existing three documents, Central Government shall lay another document - the Medium Term Expenditure Framework Statement (MTEF) - before both Houses of Parliament in the Session immediately following the Session of Parliament in which Medium-Term Fiscal Policy Statement, Fiscal Policy Strategy Statement and Macroeconomic Framework Statement are laid.

Amendments to the FRBM Act were introduced subsequent to the recommendations of 13th Finance Commission.

Concept of “Effective Revenue Deficit” and “Medium Term Expenditure Framework” statement are the two important features of amendment to FRBM Act in the direction of expenditure reforms. Effective Revenue Deficit is the difference between revenue deficit and grants for creation of capital assets. This will help in reducing consumptive component of revenue deficit and create space for increased capital spending. Effective revenue deficit has now become a new fiscal parameter. “Medium-term Expenditure Framework” statement will set forth a three-year rolling target for expenditure indicators.

As per the amendments in 2012, the Central Government has to take appropriate measures to reduce the fiscal deficit, revenue deficit and effective revenue deficit to eliminate the effective revenue deficit by the 31st March, 2015 and thereafter build up adequate effective revenue surplus and also to reach revenue deficit of not more than 2 % of Gross Domestic Product by the 31st March, 2015 and thereafter as may be prescribed by rules made by the Central Government.

Further, the Central Government may entrust the Comptroller and Auditor-General of India to review periodically as required, the compliance of the provisions of FRBM Act and such reviews shall be laid on the table of both Houses of Parliament.

Vide the Finance Act 2015, the target dates for achieving the prescribed rates of effective deficit and fiscal deficit were further extended. The effective revenue deficit which had to be eliminated by March

2015 will now need to be eliminated only after 3 years i.e., by March 2018. The 3% target of fiscal deficit to be achieved by 2016-17 has now been shifted by one more year to the end of 2017-18.

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**9.6.3 FRBM Review Committee [Union Budget 2017 – 18]**

In the backdrop of uncertainly and volatility which have become the new current of global economy the government in 2016 constituted a 5 member committee to review the implementation of the FRBMA, its important recommendations are

- **Sustainable debt path** must be principal macro-economic anchor of our fiscal policy.
- **Debt to GDP ratio** for the General Government should be 60 pc by 2023 i.e. 40 pc for central Govt. and 20 pc for state govt.
- **Fiscal Deficit :** 3 pc for the next 3 years
- **Escape Clauses :** It has provided for Escape clauses :
  (i) Deviations up to 0.5 pc of GDP from the stipulated F.D. target.
  (ii) Among the triggers, it has included for-reaching structural reforms in the economy with unanticipated fiscal implications'.

**9.6.4 Appraisal of the FRBM Legislation**

The Fiscal Responsibility and Budget Management legislation is an attempt on the part of the Central government to commit itself to fiscal discipline. The desirability of fiscal discipline is generally accepted, yet there are serious misgivings about the coverage of the legislation and its chosen targets.

- **Target of revenue deficit.** There is broad consensus that the revenue deficit is to be brought down to zero. In the past, despite general agreement on this issue successive Central governments had failed to reduce revenue deficit during the 1990s. In fact, the revenue deficit of the Central government was 3.6 per cent of the GDP in 2003-04 as against 2.4 per cent in 1996-97. This appalling situation developed on account of two reasons, First, Central tax revenue (net) to GDP ratio declined from 7.6 per cent in 1990-91 to 6.8 per cent in 2003-04. Second, interest payments, revenue subsidies, defence expenditure and other non-plan expenditures rose substantially. Whenever restrictions are imposed on the government to reduce revenue deficit, the real possibility is that the government may cut down social sector spending – especially on basic health and basic education – very severely. Which could surely be disastrous for large sections of the Indian population.

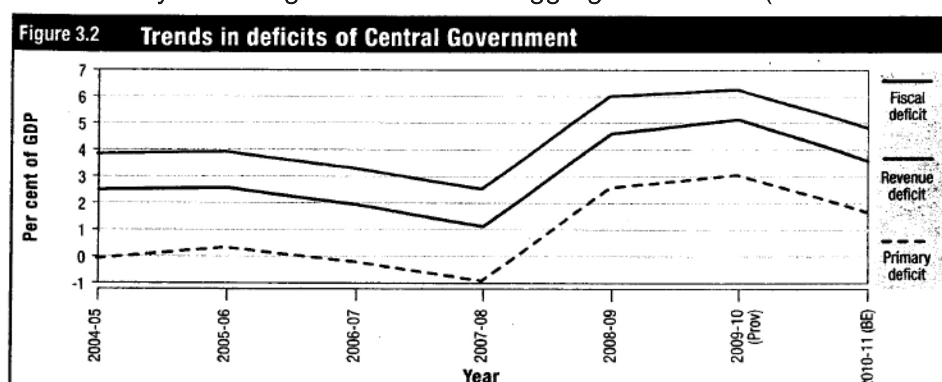
- **Low levels of capital expenditure.** One of the major defects of government finances during the post reform period has been the declining capital expenditure-GDP ratio. The capital expenditure-GDP ratio which was 5.6 per cent of GDP in 1990-91 fell to 2.7 per cent in 2001-02. After registering some increase in 2003-04 and 2004-05 (it was 3.6 per cent in 2004-05), it fell to just 1.6 per cent in 2006-07 and stood at 1.7 per cent of GDP in 2009-10. This situation may deteriorate still further under the FRBM regime. The targets for reduction of fiscal deficits and the programme for using revenue surpluses in order to retire part of the public debt may prevent any increase in government investment over the next decade.

- **Financing public expenditure.** The Fiscal Responsibility and Budget Management legislation does not address the problem of financing public expenditure in a serious manner. During the 1990s the tax-GDP ratio declined significantly. Hence, the need to raise this ratio should have received top priority under the legislation. But this was not to be. There is no target under the legislation for the tax-GDP ratio. As a matter of fact, a large number of tax concessions continue to be given most of which cannot be justified by the economists. The problem of financing public expenditure is callously dealt

with by imposing a restriction on the Central Government to borrow from the RBI to finance government expenditure, current or capital. This forces the government to incur enormously high interest cost on all its debt. Moreover, the legislation does not seem to recognize that borrowing from the central bank on a moderate scale for financing government investment serves useful purpose in an economy like ours. As a matter of fact, it has an important role to play in promoting the basic objectives of economic growth and equity and minimizing the adverse effects of debt and deficits.

**9.6.5 Trends in Deficit of Central Government (Post FRBM Act Period):**

In actual terms, the Budget for 2010-11 had estimated the level of **fiscal deficit** at Rs. 3,81,408 crore and **revenue deficit** at Rs. 2,76,512 crore. As proportions of the nominal GDP, fiscal and revenue deficits were estimated at 5.5 per cent and 4.0 per cent respectively. As proportions of the GDP as per the AE, budgeted *fiscal* and *revenue* deficits work out to 4.8 per cent and 3.5 per cent for the current fiscal. Thus, as proportions of the GDP, the recent trends in deficit indicators, post-crisis, have been influenced to some extent by the swings in the levels of aggregate demand (Table 5 and Figure 1).




Source: ECO. Survey, 2011

**Table 5 : Trends in Deficits of Central Government**

**(As per cent of GDP)**

| **Year** | **Revenue Deficit (RD)** | **Fiscal Deficit (FD)** | **Primary Deficit (PD)** | **Revenue Deficit as %age of FD** |
|---|---|---|---|---|
| **Enactment of FRBM Act** | | | | |
| 2003-04 | 3.6 | 4.5 | 0.0 | 79.7 |
| 2004-05 | 2.4 | 3.9 | 0.0 | 62.3 |
| 2005-06 | 2.5 | 4.0 | 0.4 | 63.0 |
| 2006-07 | 1.9 | 3.3 | -0.2 | 56.3 |
| 2007-08 | 1.1 | 2.5 | -0.9 | 41.4 |
| 2008-09 | 4.5 | 6.0 | 2.6 | 75.2 |
| 2009-10(P) | 5.1 | 6.3 | 3.1 | 80.7 |
| 2010-11(BE) | 3.5 | 4.8 | 1.7 | 72.5 |

Source: Eco. Survey 2010-11

FRBM : Fiscal Responsibility and Budget Management

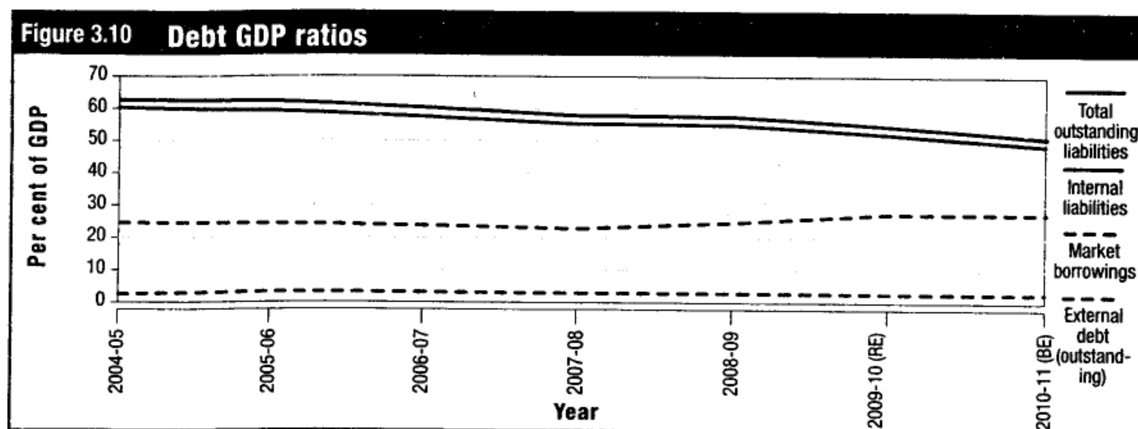
Note: The ratios to GDP at current market prices are based on the CSO’s National Accounts 2004-05 series.

### 9.6.6 Government Debt Report : Salient Features (c.f. Economic Survey, 2011)

In pursuance of the announcement made in the Budget for 2010-11 to this effect, a status paper on Government debt was presented in November 2010. The paper made a detailed analysis of the situation and chalked out a roadmap for reduction in overall debt as a percentage of the GDP for the General Government during the period 2010-11 to 2014-15. The salient features of the report are detailed as follows :

- The objectives of the debt management policy are to meet Central Government's financing need at the lowest possible long-term borrowing costs and also to keep the total debt within sustainable limits. Additionally, it aims at supporting development of a well-functioning and vibrant domestic bond market.
- The three important attributes of Government debt include source of financing, fixed interest nature of debt, and long residual maturity. Of the overall Central Government debt, about 92 per cent is internal debt and 8 per cent is external debt. Internal debt largely consists of market loans in the form of dated securities which are contracted through auction. Most of the dated securities (97 per cent) are fixed coupon and only the balance 3 per cent are floating rate bonds. The weighted average maturity of these dated securities is about 10 years while the weighted average interest rate is about 7.8 per cent per annum.
- Subsequent to the Report of the Thirteen Finance Commission which had estimated debt to GDP ratios and a roadmap for its reduction, the CSO revised the nominal GDP significantly and as per the revised data the reduction in the levels of debt as proportion of the GDP could be made even with higher than recommended fiscal deficits. As such, a higher than Thirteenth Finance Commission recommended target was preferred whereby the fiscal deficit of the Centre would be reduced to 3 per cent of the GDP by 2014-15 and accordingly debt as a proportion of the GDP would come down from 50.5 per cent in 2009-10 to 43 per cent in 2014-15.
- The outstanding debt of State Governments is estimated at 26.3 per cent of the GDP for 2009-10. However, after netting of the liabilities on account of investments made in 14-days treasury bills of Central Government, this comes down to 24.8 per cent of the GDP. The roadmap for States has been prepared with fiscal deficit as a percentage of the GDP at the level recommended by the Thirteenth Finance Commission. With the foregoing assumption on fiscal deficit, consolidated debt for State Governments is estimated to reduce from 24.8 per cent of the GDP in 2009-10 to 23.1 per cent in 2014-15.
- After factoring in the impact of Central loans to States, the consolidated debt of General Government has come down from 79.3 per cent in 2004-05 to 68.7 per cent in 2007-08. However, it has subsequently increased during the global economic crisis period to 71.1 per cent in 2008-09 and further to 73 per cent of the GDP in 2009-10. *It may be recalled that the 12th Finance Commission had recommended a consolidated debt for the Centre and State Governments at 74 per cent of the GDP for the year 2009-10. Even with slippage in 2008-09 and 2009-10 on fiscal deficit targets, the overall General Government debt at 73 per cent of the GDP in 2009-10 has remained within the recommended target.*
- The suggested roadmap for consolidated General Government debt sets a target of reduction from 73 per cent of the GDP in 2009-10 to 64.9 per cent in 2014-15. This shows a reduction of 8.1 per cent of the GDP in the consolidated debt for the General Government.

- In the roadmap suggested for debt reduction during the period 2010-11 to 2014-15, the Government's commitment towards fiscal consolidation has been reiterated. With the reduction in fiscal deficit for 2010-11, the trend witnessed in the last two years of increasing debt has been arrested. *The Government has undertaken concerted efforts to reduce the fiscal deficit gradually so as to bring down the debt as a proportion of the GDP to the pre-crisis level of 68.7 per cent by 2013-14 and further improve to about 65 per cent of the GDP in 2014-15.*




Source : Economic Survey, 2011

**9.6.7 Fourteenth Finance Commission (2012 – 2017)**

⇒ **Head & Members :**

**The FFC is headed** by YV Reddy, former RBI Governor.

Members – Abhijit Sen, M Govinda Rao, Sushma Nath and Sudipto Munale ; recommendations of the FFC were accepted by GOI on 24th February 2015.

⇒ **Major Contribution :**

More power to states – increase in the share of states in the central taxes to 42% (from current 32%) It has been the largest increase since the beginning.

It shows compositional shift in transfers' from grants to tax devolution.

⇒ **Other Recommendations :**

- Grants to states are divided into two – (a) grant to duly constituted Gram Panchayats – (b) grant to duly constituted municipal bodies.
- It (FFC) has divided grants into two parts – A basic grant and a performance–based.
- The ratio of basic to performance grant is 90 : 10 for Panchayats and 80 : 20 for municipalities

## 9.6.8 State-level finances in the post FRBMA Period

In the post-FRBMA period the performance of combined States was impressive with fiscal deficit declining to 2.4 per cent of the GDP in 2005-06 and further to 1.5 per cent in 2007-08. With the exception of 2009-10 (RE), the level of fiscal deficit had remained below the 3 per cent of GDP mark. In

2010-11 (BE), it has been estimated at 2.5 per cent of the GDP (Table 3.11 and Figure 3.11). A more noteworthy feature has been that a surplus on revenue account has been recorded in the three-year period 2007-08 and 2008-09. Revenue receipts grew at the rate of 17.6 per cent and 10.7 per cent for 2007-08 and 2008-09 respectively. Buoyant revenues of the States (as also Centre) and non-tax receipts combined with a moderate growth in revenue have helped in this regard. However, there are significant variations among States in respect of these indicators.

**Fiscal Reforms Programme for States**

With a view to improving their fiscal position, many State governments have also undertaken fiscal adjustment programmes. Even prior to the Twelfth Finance Commission. (TFC) recommending enactment of FRBM Act as a pre- requisite for States to claim the benefits under the Debt Waiver and Relief Facility, a few States had already enacted their FRBM Acts. TFC's Debt Consolidation and Relief Facility (DCRF) had a two-stage benefit scheme as incentive to the States: first, a general scheme of debt relief applicable to all States, which provided for consolidation of Central loans (from Ministry of Finance) contracted by States till March 31, 2004 and outstanding as on March 31, 2005 for a fresh term of 20 years at an interest rate of 7.5 per cent, prospectively, from the year in which they enact FRBM Acts; and second, a Debt Write-off scheme (after consolidation of Central loans) linked to fiscal performance, subject to the following conditions:

(i) Enactment of FRBM Act (required, in any case, for debt consolidation),

(ii) Reduction of revenue deficit every year starting from 2004-05, when compared to the average of the preceding three years (i.e., 2001-02, 2002-03 and 2003-04). In the process, if revenue deficit is eliminated completely by 2008-09, the State gets the full benefit of waiver,

(iii) Reduction in revenue deficit should be equal to at least the interest rate relief on account of consolidation, and

(iv) Containing fiscal deficit/GSDP (Gross State Domestic Product) ratio at the 2004-05 level in all the subsequent years.

In the post-FRBM Act period, the performance of combined States was impressive with fiscal deficit declining to 2.4 per cent of GDP in 2005-06 and further to 1.5 per cent of GDP in 2007-08. With the exception of 2009-10, the level of fiscal deficit had remained below the 3 per cent of GDP mark. A more noteworthy feature has been that a surplus on revenue account has been recorded during 2007-08 and 2008-09.

**9.6.8.1 State-level Reforms and Thirteenth Finance Commission (ThFC)**

Given the exceptional circumstances of 2008-09 and 2009-10, the fiscal consolidation process of the States was disrupted. States would be able to get back to their fiscal correction path by 2011-12, allowing for a year of adjustment in 2010-11. The stimulus packages of the Central Government as well as those announced by individual States coupled with the increased transfers recommended by the ThFC have implications for the financial position of the States in the medium term. The recommendations of ThFC for the period 2010-15 took into account the then existing and likely macroeconomic and fiscal scenarios so as to secure fiscal stability and adequate resource availability for the Centre, the States, and the local bodies. The higher levels of devolution of taxes and the inter-se

sharing thereof together with higher levels of non-Plan grants under Article 275 of the Constitution which include specific grants like grants for elementary education, outcomes and environment related grants, maintenance grants, and state-specific grants are likely to bring the combined deficit of the States down to the targeted levels faster. The borrowing ceiling for each State for the year 2010-11 has been fixed by the Government of India, keeping in view the recommendations of the ThFC based on targets for fiscal deficit. Besides, the ThFC has also provided a basis for the finances of local bodies through a basic grant and a performance grant based on a percentage of the divisible pool of the preceding year. The estimated total grant recommended for local bodies aggregates to Rs. 87,519 crore over the award period of the ThFC.

Various steps had been taken to facilitate movement towards a goods and services tax (GST) before being introduced in 2016. [These included unification of rates between central excise (goods) and service tax (services) at 10 per cent; removal of certain exemptions in central excise; widening of service tax base through inclusion of eight new services and expansion of scope of some of the existing ones; reduction in excise duty from 16 per cent to 10 per cent on medicines and toilet preparations containing alcohol (excise duty on medicinal and toilet preparations is one of the taxes to be subsumed under the GST); approval of a Mission Mode Project for the computerization of State Commercial Tax Departments].

The average combined Fiscal .Deficit. of the centre and state remained 10 pc of GDP between 1975 to 2001, largely due to high Rev.Deficit. The RBI Planning Commission, INF and WB cautioned about the unsustainability of the fiscal deficits. At the behest of IMF, India started fiscal reforms as discarded below :

**1. Policy Initiatives towards cutting Revenue Deficits**

Following steps have been taken to reduce the revenue deficit in India

**A. Cutting Down expenditure**

(i) Cutting down the burden of salaries pensions and PFs (down sizing the government for every 3, filling up one, interest cut on PF, pension reforms etc.)

(ii) Cutting down the subsides : Mixed success in rationalising Administered Price Mechanism in Petroleum, fertilisers, sugar, drugs.

(ii) Interest burden to be cut down (by going for lesser borrowings, esp. extermal borrowings).

(iv) Budgetary support to loss making PSUs.

(v) Postal Deficits to be checked with the involvement of Post Offices.

(vi) General Services : targeted subsides eg railways, power, water etc. so as to generate profit.

(vii) higher education categorised as non-merit good i.e. non-priority sector fills of institutions of professional courses revised upwards etc.

**B. Increasing Revenue Receipts**

(i) Tax Reforms

(ii) Disinvestment and Privatisation of PSUs

(iii) Surplus Forex reserves to be used in external lending and purchasing high quality sovereign bond.

(iv) State governments allowed to go for market borrowings for their plan expenditure, etc.

**2. Borrowing Programme of the Government**

(i) The ways and Means Advances (WMA) scheme commended in 1997 under which the government commits to the RBI about the amount of money it will give as part of its maket borrowing programmme. The major aim is to bring (a) transparency in public expenditure and (b) to put political responsibility on the government.

(ii) RBI will not continue to be the primary subscriber to govt securities (as committed in 1997)

**3. Fiscal Responsibility of the Governments**

(i) FRBM Act was passed in 2003 which puts constitutional obligation on the government to commit so many things as fiscal responsible comes in the public finance.

– fixing targets to cut RD and FD;

– Govts. not to borrow from RBI except by the WMA; and

– Govt. to bring in greater transparency in fiscal operations

(ii) 12th Finance Commission advised a mechanism by which state governments to go for market borrowing (without central permission) for their need of plan development provided they pass their FRBM Acts regarding cutting then RD and FD. By march 2016, all states and UTs implemented their FRAs

### 9.6.9 Nature of Fiscal Consolidation

The impact of the global financial crisis in 2011 brought to the fore the criticality of fiscal policies in combating economic shocks. With little monetary headroom in advanced economies and given the transmission lags in emerging market economies, fiscal policies were the preferred policy instruments across the globe. As per international institutional research on the subject, advanced economies were able to put in place large doses of fiscal stimuli as they had the advantage of automatic stabilizers while emerging markets, including India, had large fiscal expansion given the very low discretionary fiscal stimuli. In the fiscal consolidation phase in the post-FRBMA period (2004-05 to 2007-08), there was considerable fiscal space generated that facilitated the high levels of expansion that India had. It is therefore instructive to analyse the nature of fiscal deficits in India through their decomposition into structural and cyclical components in Appendix.

**Recent Changes :** FRBM Acts has been amended twice – in 2004 and 2012. A group of economists felt fixing fiscal deficit targets may go counter productive So GOI proposed through Union Budget 2016–17 to go for a fixed range for F.D.s in place of a fixed number.

Q. What is the level of Fiscal Deficit of India in the current year?

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## 9.7 DEFICIT FINANCING IN INDIA

Deficit financing is used in accordance with the normal budgetary practice adopted in India since independence. Briefly, it is related to the net increase in the government treasury bills and the withdrawal from cash balance of the Central Government. On the other hand, in the case of states, it is related to ways and means given by Reserve Bank of India and withdrawals from their cash balances. In short, it implies that the government puts more purchasing power into the hands of general public, than it withdraws from them. This volume of credit and turnover of goods or increasing monetization have great inflationary effects.

Deficit financing in India in the proper sense of fiscal deficit — was mainly adopted to enable the Government of India to obtain necessary resources for the Five-Year Plans. The levels of outlay laid down were of an order which could not be met only by taxation or through a revenue surplus.

The gap in resources is made up partly through external assistance but when external assistance is not enough to fill the gap, increased resort to borrowing has to be undertaken. The targets of production and employment in the plans are fixed primarily with reference to what is considered as the desirable rate of growth for the economy. When these targets cannot be achieved through resources obtained from taxation and external borrowing, additional resources have to be found. Borrowing from the market and from RBI comes in handy.

This was the position in India till the middle of 1970s. Since then, the Central Government gradually started incurring fiscal deficit i.e., market borrowings and borrowings from RBI (i.e. budgetary deficit) had to be used to cover current revenue deficit also. This is the dangerous aspect of the situation since it is bound to force the Government to land into a debt trap.

It is important to emphasise the fact that deficit financing sources which do not exist in the economy. It is only a device which helps in the transfer of resources to the Government. The real resources required for economic development must exist in the form of raw materials, equipment, skill and labour. These things cannot be created by printing money or issuing bank credit.

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### 9.7.1 Extent of Deficit Financing

Since the beginning of the First-Five Year Plan, the government has been using this source of money finance as there is a continuous increase in the public outlay. To meet with this developmental expenditure, there is an acute shortage of funds. This obviously, becomes unavoidable for the government to resort to the method of deficit financing. The volume of deficit financing during the various period has been illustrated in Table 5.

During the course of First Five-Year Plan (1951-56), the total outlay was to the extent of Rs. 1960 crore of which a gap of 333 crore was filled by deficit financing. This was about 17.0 per cent of the total budget outlay. In the Second Five-Year Plan, deficit financing was of the order of Rs. 954 crore i.e. 20 per cent but a substantially higher of Rs. 1133 crore in the Third Plan. During this period, expansion in money supply was 32 per cent against the 21 per cent rise in real income. It, thus, contained higher inflationary potentials and price rose by 34 per cent over the plan period. For fourth plan, the amount of deficit financing was to the extent of Rs. 2060 crore while the targeted amount was placed at Rs. 850 crore. This time, all the record was broken by incurring a huge deficit financing. During the Fifth Plan (1975-79), the total deficit financing was Rs. 3560 crore against the total public outlay of Rs. 40,712 crore.

In the Sixth Five-Year Plan of 1980-85, deficit financing of Rs. 15684 crore was made when total outlay for the said period amounted to Rs. 9,75,000 crore. This high dose of deficit financing was attributed to rise in prices and inevitable rise in the investment of public sector. Similarly, in the Seventh Plan, deficit financing was of Rs. 14,000 crore which further increased to Rs. 20,000 crore in Eighth Plan. The trend of deficit financing may be attributed to the typical fiscal policies adopted by the government and deficit financing has been regarded as a significant investment for financing the various development schemes. In fact, Indian Planners have justified it as a legitimate means of mobilisation of unexploited resources for productive purposes.

**Table 5 Deficit Financing in India**

(Rs. *in crore)*

| Plan | Plan Period | Plan amount | Actual amount | Percentage of total outlay |
|---|---|---|---|---|
| First Plan | 1951-56 | 1960 | 333 | 17.0 |
| Second Plan | 1956-61 | 4600 | 954 | 20.0 |
| Third Plan | 1961-66 | 8577 | 1133 | 13.0 |
| Annual Plans | 1966-69 | 6689 | 676 | 9.9 |
| Fourth Plan | 1969-74 | 16160 | 2060 | 12.5 |
| Fifth Plan | 1974-79 | 40712 | 3560 | 8.7 |
| Sixth Plan (New) | 1980-85 | 97500 | 15684 | 5.0 |
| Seventh Plan | 1985-90 | 180000 | 14000 | 7.8 |
| Eighth Plan | 1992-97 | 434100 | 20,000 | 8.6 |
| Ninth Plan | 1997-2002 | 859200 | 43346 | 5.0 |
| Tenth Plan | 2002-2007 | 1525639 | 50358 | 3.3 |
| Eleventh Plan | 2007-2012 | 3644718 | N.A. | 4.0 |

Source : Lekhi, 2009.

## 9.7.2 Effects of Deficit Financing

(i) ***Fiscal deficit and expansion in public debt and other liabilities –*** In the last decade, fiscal deficit was rising very fast and consequently, the public debt and other liabilities of the Government of India were literally multiplying. For instance, the total amount of public debt and other liabilities of the Government of India were : Rs. 3,14,560 crores in 1990-91 increased to Rs. 9,90,260 crores in 1999-2000 and then to Rs. 39,44,598 crores in 2010-11 and Rs 79 lakh crores in 2018-19.

In a matter of just 20 years from 1990-91 to 2010-11, the volume of public debt and other liabilities of the Government of India has risen nearly 12.5 times or 1250 percent. As a direct result of this growth of Government's total liabilities, the annual interest burden of the Government of India is also mounting as for instance.

***Interest Burden of the Government of India***

| | |
|---|---|
| 1980-81 | Rs. 3,500 crores |

| | |
|---|---|
| 1990-91 | Rs. 21,500 crores |
| 1999-00 | Rs. 88,000 crores |
| 2010-11 | Rs. 2,48,664 crores |
| 2017-18 | Rs 5,29,000 crores |

The annual average growth rate of public debt was around 13.5 per cent during 1990-91 and 2010-11.

Nearly 47 per cent of the current tax revenue of the Central Government goes towards payment of interest burden only. No wonder, the Government has to borrow heavily to meet revenue deficits.

**(ii)** ***Inflationary rise in prices :*** The most serious disadvantages of deficit financing is the inflationary rise of prices. Deficit financing increases the total volume of money supply in the country and, therefore, raises the aggregate demand for goods and services. In the absence of a corresponding increase in aggregate supply of goods and services, deficit financing leads to rise in the price level. It has been argued that deficit financing has been adopted in India for the purpose of development and that, therefore, increase in production will eventually check rise in prices. Besides, an appropriate policy of checking undue rise in prices may also help in bringing about economic stability.

When deficit financing goes too far, it becomes self-defeating. The rising prices are followed by rising costs and the latter cause further rise in prices, so that a spiral of inflation is set up. If in such conditions prices are not prevented from rising, the costs continue going up and the profitability of investment declines, so that investment stops or decreases. Only in the case of a moderate rise in prices is this spiral avoided and investment encouraged. Therefore, price rise due to deficit financing must be prevented from becoming inflationary.

***(iii) Forced Savings :*** When inflation occurs as a result of deficit spending must decline as a result of rising prices and, therefore, savings become forced. But it is important to remember that inflation reduces compulsorily the consumption of only fixed income earners; the consumption of higher income groups generally increases during the same period.

***(iv) Change in the pattern of investment :*** Investment caused by inflation may not be of the pattern sought under the Plan. There are certain fields of investment which receive strong encouragement from inflation. Three such fields are : inventory holding, luxury, urban construction and foreign assets. These are not necessarily the best fields in planned development. Moreover, the tendency to speculation is also strengthened. Thus, deficit financing leading to inflation may encourage types of investment which are not desirable for a developing economy.

***(v) Credit creation by banks :*** Inflationary forces created by deficit financing are reinforced by increased credit creation by banks, increase in government spending without a corresponding decrease in private spending raises the bank deposits with the Central bank. The commercial banks, therefore, find their liquidity increased and are in a position to make extra advance. Boom conditions in the economy and considerable scope for speculative gains increase the demand for bank credit. The increased bank credit then adds to the inflationary pressures started by deficit financing.

**Self Assessment Question**

1. Mention any four effects of Deficit Financing?

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-----------------------------------------------------------------------------------------------------------------------------

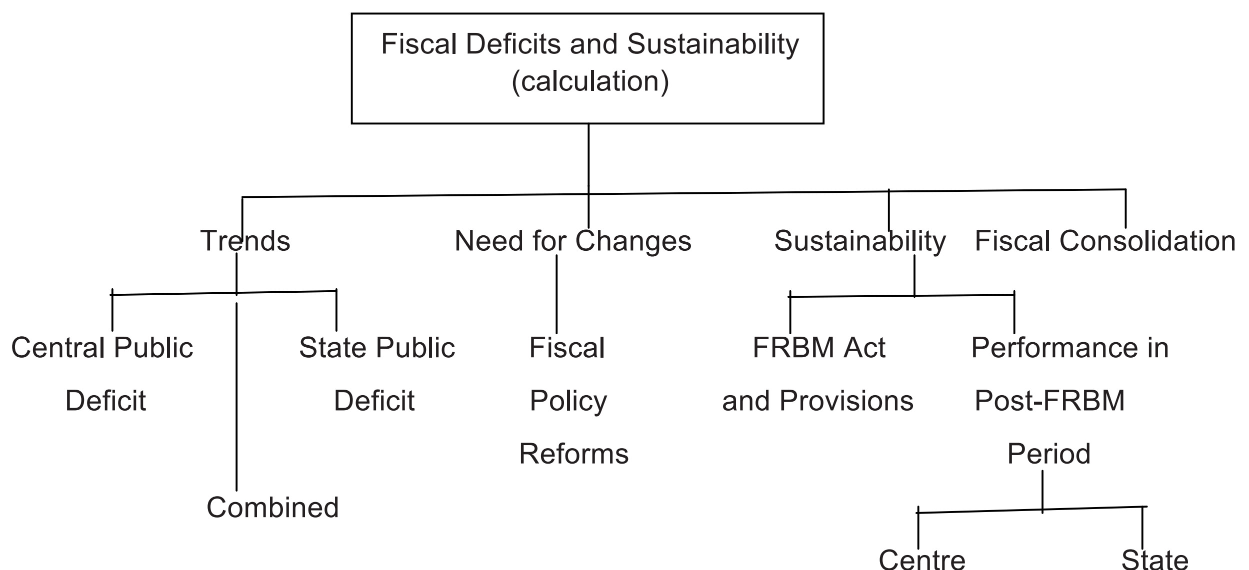
-----------------------------------------------------------------------------------------------------------------------------

**CONCLUSION**

Deficit financing could be a helpful device and a valuable instrument in promoting economic development in an under-developed country in the initial stages. The increase in the volume of money (because of deficit financing) results in higher demand for labour and other resources. As such, deficit financing is regarded as a good tool to activise a backward and developing economy. But, extreme caution is necessary in using deficit financing for economic development. For, it is intrinsically inflationary in character, and hence, proper controls are necessary. Besides, experience of other countries clearly shows that deficit financing may lead to excessive printing of currency notes which will greatly reduce the value of money. Deficit financing, like fire, is a good servant but a bad master. This is exactly what has happened in our country. With the lone exception of B.R. Shenoy, (during the formulation of the Second Plan). Indian economists at one time praised the virtues of deficit financing. Now it no longer existis in India.

## 9.7 SUMMARY

In this lesson we have studied about debt indicators of the Central and State Governments..public debt (internal and external) and outstanding liabilities. During the post- FRBM era, the deficits namely fiscal deficit, primary deficit and revenue deficit have been under check. Deficit financing is used in accordance with the normal budgetary practice adopted in India since independence.



## 9.8 GLOSSARY

- **Revenue deficit = Revenue Receipts – Revenue Expenditure**
- **Fiscal deficit = Revenue Receipts + Capital receipts (only recoveries of loans and other receipts)**

  **- Total (Revenue + Capital) expenditure**

- **Primary deficit = Fiscal deficit – Interest payments**

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## 9.12 FURTHER READINGS


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## 9.13 MODEL QUESTIONS

1. State and explain the necessity of Public Debt in a developing country like India.
2. Briefly give the trends of Public Debt in India since independence.

   Or

   Critically analyse the public debt policy of India since independence.
3. Discuss the structure of public burden in India.

4. Write short notes on :

   (i) Main Characteristics of India Public Debt of Central Government.

   (ii) Public Debt of State Governments in India.

5 5Write short notes ona) GST
b) VAT

**6** Comment upon the public debt indicators of centre and states in India since independence. How far are they sustainable?

**7** What do you know about FRBM Act in India.

8 Discuss the performance of Centre State deficits in Post-FRBM period in India.

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# APPENDIX to LESSON 9

## Lesson 9A: SUSTAINABILITY OF PUBLIC DEBT

(Note: Read the lesson thoroughly and prepare 3 page note on debt sustainability,leave minute details and Tables. Conclusion at the end of the lesson will give you the essence of the topic)

**Structure**

9A.0 Objectives

9A.1 Introduction

9A.2 Theoretical Perspectives

9A.3 Implications for Sustainability

9A.4 India's Public Debt : Findings of Research Studies

9A.5 Conclusion

9A.6 References

### 9A.0 OBJECTIVES

After going through this lesson, you shall be able to

- explain different theoretical Perspectives on public debt
- discuss implications of all discussion on debt sustainability
- elaborate on conclusions of relevant research studies on India's Public Debt

### 9A.1 INTRODUCTION

This lesson is in continuity with lesson 9 on public debt .Having gone through the details and extent of public debt at central and state level, FRBM Act and check on debt levels thereafter we proceed to study the sustainability of public debt levels in India.. The concepts used, glossary and model questions remain the same as in the lesson 9.

### 9A.2 THEORETICAL PERSPECTIVEs

- **The Neo-Classical View**

  The component of revenue deficit in fiscal deficits implies a reduction in government saving or an increase in government dissaving. In the neoclassical perspective (see, e.g. Bernheim, 1989), revenue deficit will have a detrimental effect on growth if the reduction in government saving is not fully offset by a rise in private saving, thereby resulting in a fall in the overall saving rate.

- **Keynesian View of Fiscal Deficits**

  The Keynesian view (see, e.g., Eisner, 1989), in the context of the existence of some unemployed resources, envisages that an increase in autonomous government expenditure, whether investment or consumption, financed by borrowing would cause output to expand through a multiplier process. The traditional Keynesian framework does not distinguish between alternative uses of the fiscal deficit as between government consumption or investment expenditure, nor does it distinguish between alternative sources of financing the fiscal deficit through monetisation or external or internal borrowing. In fact, there is no explicit budget constraint in the analysis.

- **Ricardian Equivalence Perspective**

  In the perspective of Ricardian equivalence (e.g. Barro, 1974, 1976, 1979, 1987, 1989), fiscal deficits are viewed as neutral in terms of their impact on growth. The financing of budgets by deficits amounts only to postponement of taxes. The deficit in any current period is exactly equal to the present value of future taxation that is required to pay off the increment to debt resulting from the deficit. In other words, government spending must be paid for, whether now or later, and the present value of spending must be equal to the present value of tax and non-tax revenues. Fiscal deficits are a useful device for smoothening the impact of revenue shocks or for meeting the requirements of lumpy expenditures, the financing of which through taxes may be spread over a period of time.

## 9A.3 SUSTAINABILITY OF PUBLIC DEBT

The issue of fiscal deficit assumed importance in India in the late eighties when the fiscal deficit to GDP ratio rose to levels above 7 percent. In the early nineties, it was above 9 percent, and after some improvement, it started rising again, crossing the threshold of 10 percent of GDP in 2001-02.

The issue of sustainability of debt should be considered as distinct from that of solvency. Sustainability can be seen as the capacity to keep balance between costs of additional borrowing with returns from such borrowing, which could be in the form of higher growth that results in higher government revenues that can be used for servicing the additional borrowing. Sustainability issues should be viewed for combinations of debt and fiscal deficit, and not in isolation for either debt or fiscal deficit. Thus, a fiscal deficit of 10 percent combined with say a debt-GDP ratio of 100 percent will have sustainability implications that are quite different from those of a 10 percent fiscal deficit when the debtGDP ratio is 50 percent. Thus, sustainability should not be treated as synonymous with stability of the debt-GDP ratio at whatever level it might have reached. The level of debt in combination with interest rate determines the level of interest payments. Fiscal deficit minus interest payments determine primary deficit. Primary deficit represents the extent of borrowing used by the government for current expenditures, revenue and capital. The remaining part of fiscal deficit is claimed by interest payments, which are transfer payments that go back into the income expenditure stream. In particular, government interest payments add to the disposable incomes in the private sector. This has implications for government revenues as well.

### 9A. 3.1 Debt sustainability Condition proposed by Domar

**According to Domar** (1944 ) the problem of debt sustainability is associated with the rates of growth of national income. He opines that the problem of the debt burden is essentially a problem of achieving a growing national income. A rising income is of course desired on general grounds, but in addition to its many other advantages it also solves the most important aspects of the problem of the debt. The faster income grows, the lighter will be the burden of the debt. To quote him, while analyzing growing debt in USA and other developed countries in the years succeeding the Great depression, "When post-war fiscal policy is discussed, the public debt and its burden loom in the eyes of many economists and laymen as the greatest obstacle to all good things on earth. The remedy suggested is always the reduction of the absolute size of the debt or at least the prevention of its further growth. If all the people and organizations who work and study, write articles and make speeches, worry and spend sleepless nights-all because of fear of the debt-could forget about it for a while and spend even half their efforts trying to find ways of achieving a growing national income, their contribution to the benefit and welfare of humanity - and to the solution of the debt problem - would be immeasurable."

•Domar Sustainability Condition:

$$t = ( \alpha / r ) * i$$

**Where t** =tax rate,

**α** = rate of borrowing

**r** = rate of growth of the economy .

**i** = rate of interest on government borrowing

**9A.3INDIA'S PUBLIC DEBT AND ISSUE OF SUSTAINABILITY**

**( Findings of Two Important Research Studies)**

**I.** How has India's Public Debt evolved since 1980s (upto 2013) has been depicted by an RBI study authored by Balbir Kaur and Atri Mukherjee(2016 ) titled "Threshold Level of Debt and Public Debt Sustainability: The Indian Experience" during the period 1980s to 2013 (https://m.rbi.org.in/scripts/bs_viewcontent.aspx?Id=2843). Here we will discuss relevant information on public debt of centre and state governments in India and conclusions regarding debt sustainability as follows:

Fiscal expansion financed through debt and the resultant public debt accumulation significantly influence the economy both in the short-run as well as the long run. Debt per capita may not be bad. Actually, it depends on the utilisation of funds raised through these borrowings. In case it is used for capital formation, it can contribute to the real income of future generation and add to repayment capacity of the government as well. On the contrary, the use of borrowings to finance only current expenditure poses the risk of debt which may rise to unsustainable levels.

In case of India, the fiscal position of the central and state governments had remained comfortable in the first three decades since Independence. The revenue account of the central government turned into deficit in the year 1979-80, while the state finances exhibited signs of fiscal stress since the mid-1980s. Given this backdrop, both the centre and states started with

moderate debt levels, with the consolidated public debt to GDP ratio at 47.9 per cent in end March 1981. However, the debt position deteriorated steadily thereafter to reach a high of 72.9 per cent in end March 1992. This was also the period characterised by high primary deficits with the primary deficit-GDP ratio at 6.2 per cent in 1986-87, giving rise to concerns regarding high growth in public debt of India (Seshan, 1987; Report of the Comptroller and Auditor General of India, 1988).

There was some improvement in debt position during the period 1992-93 to 1997-98, which reflected the impact of macro-economic and structural reforms undertaken in the aftermath of the balance of payments crisis in the early 1990s (which you will study in detail in Semesters 3 and 4). However, this improvement could not be sustained, as all the key deficit indicators of the central and state governments deteriorated sharply thereafter, due to additional expenditure liabilities linked to the implementation of the Fifth Pay Commission award as also sluggish revenue growth on account of poor performance of public sector undertakings. Reflecting these developments, the debt liabilities accumulated sharply and the public debt-GDP ratio increased to 83.2 per cent in end March 2004.

**Fiscal Consolidation and Public Debt Growth:** With the enactment and implementation of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003, fiscal reforms initiated at the central government level. Around the same time, most states also operationalised fiscal rules with a focus on a phased improvement in their fiscal deficit and debt -gross state domestic product (debt-GSDP) ratios. The state government initiatives were also supported by the implementation of Debt Swap Scheme (DSS) from 2002-03 to 2004-05 and Debt Consolidation and Relief Facility (DCRF) from 2005-06 to 2009-10. While the DSS allowed the state governments to pre-pay their high cost loans from the central government, the DCRF provided for debt consolidation and debt/interest relief on outstanding central government loans, subject to the enactment of the FRBM Act and reduction in revenue deficit, as per stipulated rules, during the award period. As a result of these measures, the outstanding debt-GDP ratio of the states at the consolidated level declined from 31.8 per cent in end March 2004 to 26.6 per cent in end March 2008. A similar improvement was evident in debt position of the central government. This trend has continued thereafter (barring 2008-09) with the public debt-GDP ratio of the general government (central and state governments) declining to 66.0 per cent in end March 2013.

Public debt to government revenue ratio, which is a useful indicator of the vulnerability of a country's public finances and the solvency of the government, shows that India's public debt as a ratio to revenue is very high, although it has declined during the recent period (Table I). So, the country's capacity to support high levels of public debt is constrained by its ability to raise revenues.

**Table I : Fiscal Indicators for India** **(percent)**

| India | 2006 | | | | 2012 | | | | 2013 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Debt-GDP | Debt-Revenue | Overall Balance-GDP | Primary Balance-GDP | Debt-GDP | Debt-Revenue | Overall Balance-GDP | Primary Balance-GDP | Debt-GDP | Debt-Revenue | Overall Balance-GDP | Primary Balance-GDP |
| | 77.1 | 379.8 | -6.2 | -1.3 | 66.7 | 343.8 | -8.0 | -3.6 | 67.2 | 342.9 | -8.5 | -3.8 |

Source: World Economic Outlook Database and Fiscal Monitor, 2013, International Monetary Fund

For the period 1955-2000 a study on deficits in India found that even with persistence of primary deficits for a long period of time, the debt to GDP ratio could be contained in India as the GDP growth exceeded the interest rates. Available data shows that the primary surplus was recorded only in two years: 2006-07 and 2007- 08. Considering the fact that the interest rate - growth rate differential has gradually narrowed down with a progressive move towards market determination of yields on government debt issuances and given the difficulties in sustaining high rates of growth, it would be challenging to maintain fiscal/debt sustainability in absence of a turnaround in primary balance position in the medium to long run [Rangarajan and Srivastava (2003, 2005)].

**Public Debt and Growth in India**

There is a general belief among the economists that slower growth is associated with higher level of debt. Several economists argue that growth slows down sharply when the government debt to GDP ratio exceeds a certain threshold level as conceptualized

**Table 4: Fiscal Sustainability of General Government : Indicator-based Analysis**

| Sl. No. | Indicators | Symbolic Representation | Phase-I (1981-82 to 1991-92) | Phase II (1992-93 to 1996-97) | Phase III (1997-98 to 2003-04) | Phase IV (2004-05 to 2012-13) |
|---|---|---|---|---|---|---|
| 1 | Rate of growth of public debt (D) should be lower than rate of growth of nominal GDP (G) | D - G < 0 | 4.45 | - 2.84 | 4.14 | - 2.98 |
| 2 | Rate of growth of public debt (D) should be lower than effective interest rate (i) | D - i < 0 | 12.94 | 5.26 | 5.82 | 4.21 |
| 3 | Real rate of interest (r) should be lower than real output growth (g) | r - g < 0 | -7.67 | -7.58 | -1.57 | -6.67 |
| 4(a) | Public debt to revenue receipts ratio should decline over time | D / RR ↓↓ | 3.37 | 3.90 | 4.34 | 3.63 |
| 4(b) | Public debt to tax revenue ratio should decline over time | D / TR ↓↓ | 4.22 | 4.88 | 5.41 | 4.45 |
| 6(c) | Interest burden defined by interest payments (IP) as a per cent to GDP should decline over time | IP / G ↓↓ | 3.28 | 4.86 | 5.71 | 5.06 |

Source:

There is, however, no consensus regarding the threshold level of debt, beyond which the growth suffers Reinhart and Rogoff (R&R) in their paper “Growth in a time of Debt” (2010), found that growth rates in both developed and developing countries slows down sharply when the government debt to gross domestic product (GDP) ratio exceeds a threshold level of 90 per cent. The median growth falls by one per cent and the average growth falls by considerably more for debt-GDP ratios above the threshold of 90 per cent. In other words, slower growth is associated with higher debt.

Growth in emerging markets (EMs) slows down by an annual two percentage points when their external debt reaches 60 per cent of GDP and the decline is even sharper for external debt levels in excess of 90 per cent of GDP.

*The necessary conditions for debt sustainability are- shown in indicators 1 and 3 of* **Table 4**. These were fulfilled during the periods of fiscal consolidation, viz., phases II and IV. But the sufficient condition of generating primary surpluses could not be met during any of the four phases. In fact, with the exception of 2006-07 and 2007-08, primary balances of the general government remained in deficit during the last three decades.

Rangrajan and Srivastva (2003) opine that for stabilization of debt-GDP ratios at current or reduced levels,focus on reducing primary balance is necessary as observed by them during 2001-03 in case of India. Favourable interest rate-growth differential has, however, more than compensated for the absence of primary surpluses, resulting in a sharp decline in debt-GDP ratio between 2004-05 and 2010-11, barring a brief increase in the immediate aftermath of the global financial crisis. With a decline in the interest rate-growth differential and an increase in primary deficits, the growth in public debt has increased in 2012-13.

Although the debt-GDP ratio declined in phase II reflecting the impact of reforms, debt sustainability indicators in terms of debt service burden (as expressed by indicators 5 and 6 in Table 2) deteriorated.

The debt service burden deteriorated further in phase III as it was accompanied with an up-trend in interest rates. However, this trend reversed in phase IV due to the combined impact of improvement in revenue buoyancy (i.e. increasing tendency) and reduction in interest rates from the high levels seen in the 1990s and early 2000s. The average interest payments have, however, continued to pre-empt around one-fourth of revenue receipts during phase IV, which is higher than the tolerable ratio of interest burden. The high level of incremental debt which was acquired during 2008-09 and 2009-10 has contributed significantly to the rising interest burden in recent year.

## II. DEBT SUSTAINABILITY AT SUB NATIONAL LEVEL

Based on analysis by Balbir et al(2018),[for which data on state government expenditure, revenues and outstanding level were taken from the 'Handbook of Statistics of the Indian Economy', published by the Reserve Bank of India for the period 1980–1981 to 2015–2016 for 20 Indian states, for which data on all the relevant variables were available for the entire time period],the following observations can be made:

The fiscal position of states in India, remained comfortable in the first three decades since independence, but it showed signs of fiscal stress since the mid-1980s. The average debt-GDP ratio rose slightly from 18.3% during the 1980s to 20.8% during the 1990s.

Thereafter evolution of debt position of state governments in India underwent several phases: a comfortable position prior to 1997–1998 to a phase of sharp deterioration and fiscal stress during 1997–1998 to 2003–2004 and then to a phase of significant improvement since 2004–2005. While the debt liabilities of states increased sharply during 1997–1998 to 2003–2004, the subsequent period has been a phase of consolidation, attributable, among others, to the implementation of fiscal rules through the enactment of Fiscal Responsibility and Budget

Management (FRBM) Acts/Fiscal Responsibility Legislations (FRLs) at the state level in early 2000s. (see chart 1).

These fiscal consolidation initiatives were complemented by debt and interest relief measures of the central government, and also supported by a favourable macroeconomic environment following the high growth phase and a reversal of the interest rate cycle in the mid-2000s.

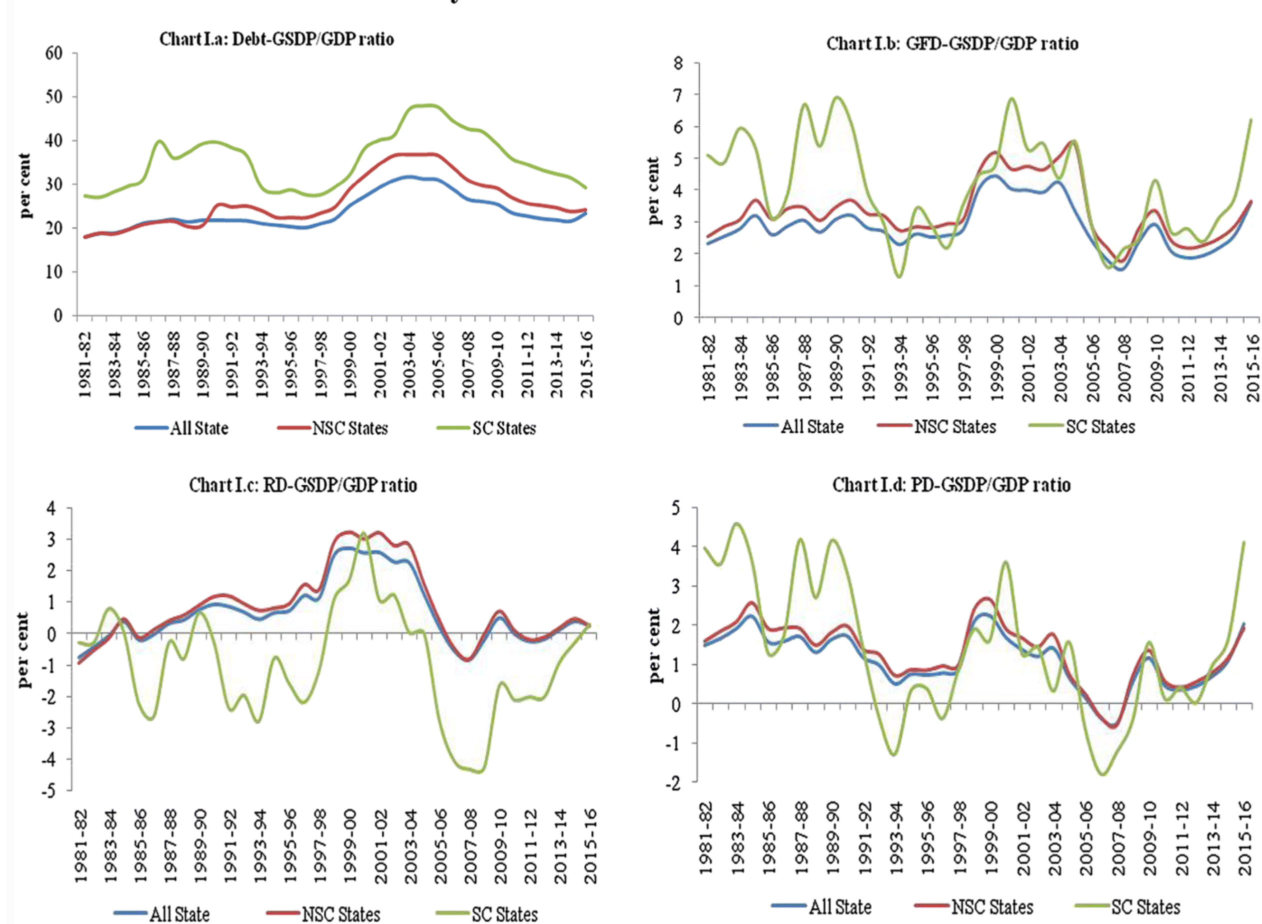
An analysis based on various indicators of debt sustainability in different phases during the period 1981–1982 to 2015–2016 (see Table ) reveals that

the rate of growth of debt of states at the aggregate level exceeded the nominal GDP growth rate during Phase I (1981–1982 to 1991–1992), Phase III (1997–1998 to 2003–2004) and Phase V (2012–2013 to 2015–2016).

However, the *Domar stability condition that the real rate of interest on debt (i.e., effective interest rate adjusted for inflation) should be lower than the real GDP growth* was fulfilled in all the phases except in Phase III(1997–1998 to 2003–2004) when the real rate of interest was almost equal to the real output growth.

Here, Effective interest rate = current interest payments as a per cent of outstanding liabilities of state governments in the previous year.

**Chart I: Key Fiscal Indicators of State Governments**



Note: Key Fiscal Indicators of State Governments. 1. Ratios pertaining to 'All States' are as percentage to GDP. 2. NSC and SC refer to non-special and special category states, respectively.

Source : Balbir Kaur,,Atri Mukherjee &Anand Prakash Ekka(2018) . Debt sustainability of states in India: An assessment.*Indian Economic Review*.

The period from 1997–1998 to 2003–2004 was, however, marked by a sharp deterioration in key fiscal indicators of states, which was reflected in an increase of around 6 percentage points in average debt-GDP ratio to 26.8% and further to a high of 31.8% in end-March 2004.

Majority of the states adhered to the debt targets set for them by the Thirteenth Finance Commission (FC-XIII) for the period 2010–2014, even as some of them breached their respective debt targets and continued to have unsustainable debt positions. In the recent period, the signs of fiscal stress have re-emerged on the back of poor performance of state public sector enterprises. With several states assuming additional debt liabilities as part of financial and operational restructuring of state power distribution companies, there is an inherent risk in terms of debt servicing capacity and soundness of fiscal performance parameters of states. In addition, the adoption of farm loan waivers by different state governments, viz, Uttar Pradesh, Punjab, Rajasthan, Maharashtra and Karnataka is likely to further enhance their fiscal burden.

Most of studies have shown declining debt-GSDP ratios at the state level and also attribute this improvement to their growth performance and implementation of fiscal rules under FRBM Act during 2003–2012. It is also feared that a slowdown in growth momentum could pose risk to the achievement of envisaged gross fiscal deficit and debt-GSDP targets under the medium-term scenario. The state wise details are available at following table link. The implementation of the rule-based fiscal discipline mechanism since the early 2000s led to a gradual move towards sustainability of their fiscal and debt positions, with majority of the states achieving the thirteenth Finance Commission (FC-XIII) targets as also their self-imposed targets.

## Table 2 States' Debt-GSDP/GDP ratio (Average) (in per cent)

From: Debt sustainability of states in India: An assessment

| States | (1981–1982 to 1991–1992) | (1992–1993 to 1996–1997) | (1997–1998 to 2003–2004) | (2004–2005 to 2011–2012) | (2012–2013 to 2015–2016) |
|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 |
| Andhra Pradesh | 18.8 | 20.6 | 27.3 | 27.7 | 21.4 |
| Bihar | 42.3 | 53.9 | 56.0 | 43.0 | 25.2 |
| Chhattisgarh | | | 25.5 | 18.5 | 14.5 |
| Goa | 51.5 | 41.4 | 37.1 | 31.0 | 26.3 |
| Gujarat | 17.6 | 19.9 | 30.6 | 30.3 | 23.9 |
| Haryana | 18.6 | 18.7 | 24.6 | 20.8 | 21.6 |
| Jharkhand | | | 23.6 | 25.4 | 23.1 |

| States | (1981–1982 to 1991–1992) | (1992–1993 to 1996–1997) | (1997–1998 to 2003–2004) | (2004–2005 to 2011–2012) | (2012–2013 to 2015–2016) |
|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 |
| Karnataka | 17.5 | 17.9 | 22.7 | 24.0 | 22.6 |
| Kerala | 14.6 | 23.7 | 31.8 | 33.3 | 31.5 |
| Madhya Pradesh | 27.0 | 27.9 | 29.9 | 33.2 | 22.2 |
| Maharashtra | 14.9 | 15.6 | 23.9 | 25.3 | 19.7 |
| Odisha | 28.3 | 34.4 | 47.5 | 34.2 | 17.6 |
| Punjab | 25.3 | 32.9 | 41.5 | 38.4 | 32.4 |
| Rajasthan | 25.7 | 25.4 | 37.8 | 37.6 | 27.1 |
| Tamil Nadu | 14.0 | 17.4 | 21.9 | 21.9 | 19.6 |
| Uttar Pradesh | 23.8 | 32.9 | 43.6 | 44.8 | 32.8 |
| West Bengal | 19.8 | 23.0 | 36.9 | 45.0 | 35.7 |
| NSC States | 20.7 | 23.3 | 31.2 | 31.3 | 24.5 |
| SC States | 34.1 | 30.1 | 36.7 | 41.9 | 31.7 |
| All States | 18.3 | 20.8 | 26.8 | 26.9 | 22.1 |

1. All Ratios pertaining to 'All States' are percentages to GDP. All variables are in nominal terms. NSC and SC refer to non-special and special category states, respectively.
2. The state of Andhra Pradesh includes the liabilities of newly formed state Telangana.

*The loan raising powers of the Indian states are regulated by the Article 293 of the Indian Constitution which stipulates* --

"a state may not without the consent of the Government of India raise any loan if there is still outstanding any part of a loan which has been made to the state by the Government of India or by its predecessor Government, or in respect of which a guarantee has been given by the Government of India or by its predecessor Government".

This clarifies that the state governments do not have unrestricted powers to borrow as long as they are indebted to the Centre. Further, states are also prohibited from borrowing abroad with the exception of loans from multilateral financial institutions intermediated by the Central government. The FRBM Review Committee led by Chairperson: N. K. Singh ( 2017) has suggested to use debt as the primary target for fiscal policy.

A state-wise position in respect of debt sustainability indicators for 17 non-special category states is presented by the autors (Balbir et al)in their study under consideration( see link for the study details of their Table 4).

It is shown that the rate of growth of GSDP was higher than the effective interest rate in all the states in the last two phases, even as the gap between the two narrowed down in Phase V (Table 4a). Furthermore, the rate of growth of public debt turned out to be higher than the GSDP growth in several states in Phase V, which is a cause of concern (Table 4b). The debt redemption pressure is also evident from the ratio of debt redemption (principal and interest payments) to total debt receipts, which shot up from 64.1% during 1981–1982 to 2003–2004 to 79.8% during 2004–2005 to 2015–2016. This is indicative of a smaller proportion of borrowed funds being available for productive uses by the state governments during the latter period.

## Table 4 Indicators of Debt Sustainability. a Rate of growth of GSDP (g) should be higher than effective interest rate i; $g - i > 0$, b Rate of growth of public debt (k) should be lower than growth rate of nominal GSDP (g); $k - g < 0$

From: Debt sustainability of states in India: An assessment

| State | (1981–1982 to 1991–1992) | (1992–1993 to 1996–1997) | (1997–1998 to 2003–2004) | (2004–2005 to 2011–2012) | (2012–2013 to 2015–2016) |
|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 |
| **Table 4A** | | | | | |
| Andhra Pradesh $ | 8.4 | 6.3 | −0.5 | 7.6 | 7.7 |
| Bihar | 6.8 | 3.2 | −0.5 | 9.6 | 12.1 |
| Chhattisgarh | | | −0.6 | 9.8 | 6.9 |
| Goa | 9.1 | 12.2 | 5.5 | 11.8 | 1.3 |
| Gujarat | 5.6 | 10.8 | −0.3 | 7.9 | 5.3 |
| Haryana | 7.0 | 4.4 | 0.5 | 8.6 | 5.5 |
| Jharkhand | | | −2.5 | 5.7 | 6.0 |
| Karnataka | 7.3 | 6.4 | −0.7 | 7.5 | 6.1 |
| Kerala | 5.8 | 3.1 | −1.0 | 5.2 | 5.6 |
| Madhya Pradesh | 7.6 | 4.4 | −0.5 | 7.1 | 11.5 |
| Maharashtra | 6.3 | 9.7 | −0.2 | 8.0 | 6.1 |
| Odisha | 5.7 | 2.5 | 1.0 | 8.8 | 5.8 |
| Punjab | 7.8 | 4.5 | −1.4 | 5.5 | 3.9 |
| Rajasthan | 8.1 | 6.6 | −1.4 | 8.3 | 3.6 |
| Tamil Nadu | 7.0 | 7.6 | −1.4 | 8.8 | 7.8 |
| Uttar Pradesh | 6.4 | 4.9 | −2.0 | 7.2 | 5.5 |
| West Bengal | 5.5 | 3.2 | −0.1 | 4.6 | 7.0 |
| NSC States | 6.7 | 7.1 | −0.7 | 7.3 | 6.5 |

| State | (1981–1982 to 1991–1992) | (1992–1993 to 1996–1997) | (1997–1998 to 2003–2004) | (2004–2005 to 2011–2012) | (2012–2013 to 2015–2016) |
|---|---|---|---|---|---|
| 1 | 2 | 3 | 4 | 5 | 6 |
| SC States | 7.5 | 6.9 | −0.1 | 6.4 | 7.3 |
| All States | 7.1 | 6.3 | 0.0 | 7.5 | 3.3 |

**Table 4B**

| State | (1981–1982 to 1991–1992) | (1992–1993 to 1996–1997) | (1997–1998 to 2003–2004) | (2004–2005 to 2011–2012) | (2012–2013 to 2015–2016) |
|---|---|---|---|---|---|
| AndhraPradesh | 0.9 | 0.5 | 7.4 | −5.2 | −4.3 |
| Bihar | 4.2 | −0.9 | 2.1 | −10.2 | −4.8 |
| Chhattisgarh | | −11.1 | −0.5 | −11.2 | 8.1 |
| Goa | −1.1 | −11.4 | 2.1 | −7.3 | 3.4 |
| Gujarat | 6.9 | −8.3 | 10.5 | −4.4 | −3.0 |
| Haryana | 1.2 | −0.1 | 6.4 | −4.6 | 8.0 |
| Jharkhand | | −9.4 | −6.6 | 2.0 | 2.8 |
| Karnataka | 1.3 | 0.2 | 7.0 | −2.1 | 0.4 |
| Kerala | 3.9 | −0.7 | 9.1 | −1.7 | 0.7 |
| Madhya Pradesh | 2.8 | −1.6 | 3.2 | −4.9 | −7.5 |
| Maharashtra | 5.2 | −3.9 | 10.3 | −4.6 | −4.4 |
| Odisha | 2.9 | 2.1 | 4.9 | −11.9 | −8.0 |
| Punjab | 7.9 | −0.8 | 6.3 | −5.3 | 0.6 |
| Rajasthan | −0.6 | 0.1 | 8.6 | −7.6 | 7.6 |
| Tamil Nadu | 3.1 | −1.1 | 7.8 | −4.7 | −2.5 |
| Uttar Pradesh | 5.5 | 0.3 | 7.8 | −5.3 | 1.6 |
| West Bengal | 2.4 | 2.3 | 11.4 | −2.2 | −6.1 |
| NSC States | 3.7 | −2.5 | 8.1 | −5.1 | −1.7 |
| SC States | 3.8 | −7.7 | 9.0 | −4.3 | −4.8 |
| All States | 2.1 | −1.8 | 7.5 | −5.1 | 1.4 |

1. $The state of Andhra Pradesh includes newly formed state Telangana
2. All variables are in nominal terms. NSC and SC refer to non-special and special category states, respectively

Debt becomes unsustainable, if fiscal deficits follow a course that leads to a self-perpetuating rise in the debt-GDP ratio, which affects negatively the growth rate and positively the interest

rate, such that the existing levels of primary government expenditures cannot be sustained, given the configuration of growth and interest rates. A sustainable debt-deficit combination would be stable in terms of debt/GDP ratio and fiscal-deficit GDP ratio consistent with the permissible levels of primary expenditures. If the real rate of growth of the economy is more than the real rates of interest debt is sustainable (with a primary budget balance).

SAQ

Q. Write a short note on sustainability of Public debt of India.

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## 9A.5 CONCLUSION

In this lesson we have read about Domars concept of debt sustainability which says that growth rate of GDP should be higher than the rate of growth of public debt rather than cursing the increasing debt. Rangrajan opines that primary deficits should be under control that is growth of interest burden can be the worrying factor. The cross country studies observe various limits of public debt –GDP ratios eg 60 pc or 90 pcs as the determining factor for the sustainability of public debt.

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## 9A.6 FURTHER READING


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# DEFICIT FINANCING

## (As a Theoretical Tool)

**Structure**

10.0 Objectives
10.1 Introduction
10.2 Deficit Financing: Concept
10.3 Deficit Financing and Budget Deficit
10.4 Techniques of Deficit Financing
10.5 Objectives of Deficit Financing
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10.7 Role of Deficit Financing
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## 10.0 OBJECTIVES

After going through this lesson, you shall be able to :

- explain Deficit Financing and Budget Deficit
- discuss the techniques, objectives of deficit financing
- describe reasons, role and uses of deficit financing
- delineate the problems, safe limit of deficit financing

## 10.1 INTRODUCTION

For the welfare of the public at large, the government raises funds from the market. It adds to the income of the government and adds to its liabilities also. Deficit financing is also a tool to raise funds to perform government functions. In this lesson we shall study about theoretical aspects of Deficit Financing.

## 10.2 DEFICIAT FINANCING : CONCEPT

The term, however, has been differently used in the advanced countries of West and in the developing countries like India. In the western countries deficit public spending or deficit financing is referred to excess of expenditure over revenue receipts financed through public loans and the creation of new money. In other words, deficit financing takes place even when a budget gap is covered by loans. In fact, any expenditure of the government beyond its current income is known as deficit financing. Therefore, in the Western sense the financing of all public expenditure in excess of public revenue in current account is called as deficit financing. The deficit financing was an important issue of financing of five year plans till 1997; and it is non-existent since then.

**Explanation in Indian Context**

In India, the term, however, has been referred in a different manner. According to the Indian Planning Commission, "the term deficit financing is used to denote the direct addition to gross national expenditure through budget deficits, whether the deficits are on current revenue or of capital account. The essence of such a policy lies, therefore, in government spending in excess of the revenue it receives in the shape of taxes, earning of state enterprises, loans from the public, deposits, funds, and other miscellaneous sources. The government may cover either by running down its accumulated balances or borrowing from the banking system (mainly from the Central Bank of the country and thus creating new money)." Thus, deficit financing is regarded when the Government spends more than it gets through taxes and other sources of revenue and loans from the public and also borrows from the banking system or by running down its cash balances. In practice, this type of borrowing is done from the Reserve Bank. The government transfers its securities to the Reserve Bank, on the strength of these securities, the bank is empowered to issue more currency notes, which we put on circulation by making increase payments on behalf of the government. This process implies, of course, creation of new money.

Indian Planning Commission, in the First Five-Year Plan noted deficit financing is used to denote deficits whether the deficits are on revenue or capital accounts." It simply refers to the expenditure of the Government over and above the aggregate receipts of revenue account and capital account. In needs to be mentioned that in India all types of borrowing from public, commercial banks and income from public enterprises are not covered under deficit financing while they are regarded as receipts of the capital. In advanced countries, the position is different.

## 10.3 DEFICIT FINANCING AND BUDGET DEFICIT

Deficit Financing is different from Budget Deficit. The *budget deficit* is incurred with the effect on liquid assets held by the public. Therefore, the effect of fiscal operations are measured by the increase in the volume of money. This makes the point clear that deficit financing is wider concept rather than budget deficit. To make the distinction between the Western as well as the Indian concepts, former refers to the expenditure incurred by the government in excess of its current revenue and does not treat borrowings as the revenue of the government, while the latter denotes expenditure by the government current receipts in the form of taxation, revenue receipts and borrowing. In a Western sense, this increase in public expenditure due to public borrowings can be called as deficit financing. Moreover, budget deficit is generally financed out of market borrowing. It is non-inflationary character as budget deficit is financed out of saving of the public. On the other hand, in Indian sense, budget deficit is financed through borrowing from the Reserve Bank (creating new currency and reducing government cash balances). It is mostly of inflationary character.

> *"The financing of a deliberately created gap between public revenue and public expenditure, the method of financing restored to being borrowing of a type that result in a net addition to national outlay or aggregate expenditure."*

*Dr. V.K.R.V. Rao*

## 10.4 TECHNIQUES OF DEFICIT FINANCING

There are mainly three techniques of deficit financing :

(a) Borrowing from Central Banks.

(b) Withdrawal of its cash balances from the Central Bank.

(c) Issuing of New Currency, i.e., printing of more notes and putting into circulation.

## 10.5 OBJECTIVES OF DEFICIT FINANCING

Major objectives of deficit financing are explained below :

- The deficit financing is a method of meeting the financial needs of the government during crisis period such as war because the government tends to resort in order to require a quick command over resources to meet the growing war expenses.
- Keynes advocated as an instrument of economic development level of output and employment.
- It is advocated for the mobilisation of surplus, idle and unutilized resources for promoting rapid economic growth in underdeveloped economics as well as in developing economics.
- It is advocated as essential for financing the plans.
- In democratic underdeveloped countries it is preferable to taxation due to political reasons.
- To raise the level of effective demand and stimulate private investment.
- To mobilise resources for financing economic planning.
- To divert undesirable and unproductive sources into the channel of desirable and productive channels of the economy.

## 10.6 REASONS FOR RESORTING TO DEFICIT FINANCING

Generally deficit financing is resorted to due to the following reasons :

**(a) To mobilise the domestic resources :** Keeping in view the inadequate and insufficient internal borrowings, deficit financing has been recognized as a tool to the low income spread among the vast masses to mobilise domestic resources on a massive scale.

**(b) To set the desired output of Production and Employment :** Being under-developed country, domestic resources, borrowing could not bring the desirable result of production and employment. This has further compelled the government to adopt deficit financing.

## 10.7 ROLE OF DEFICIT FINANCING

The justification or role of deficit financing can be narrated in the following manner :

(a) Deficit financing and war expenditure.

(b) Deficit financing and depression.

(c) Deficit financing and price level.

(d) Deficit financing and employment.

(e) Deficit financing and distribution of income.

(f) Deficit financing an economic growth.

**Activity**

Q. 1 Do we practice Deficit Financing in India? Explain in brief.

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1. **Deficit Financing and War Expenditure :** During war period, it becomes difficult for the government to finance the war expenditures through its normal method of resources, thus making the government resort to deficit financing. In effect, it curtails other use of various goods and services. The rise in prices takes place because on one hand, increased purchasing power is injected into the economy through war purchases and on the other hand, the resources are mobilised from the general public not for increasing the production or raising the productive capacity of the economy but simply for throwing into war effort. The expenditure made on such unproductive channels is not useful for the betterment of the economy. Thus, this type of expenditure gives rise to the purchasing power and in the demand for goods but actually, there is decline in the availability of goods. Hence, during war-period deficit financing leads to inflationary pressures on the economy unnecessarily.

2. **Deficit Financing and Depression :** In the period of depression, deficit financing is a powerful and indispensable tool to pull the economy out of it. There is a fall in effective demand and this fall is accentuated by falling employment. Deficiency in demand leads to unemployment, which in turn, leads to more and more unemployment. This vicious circle continues and depression goes into the depth of it. Thus public expenditure through public works projects helps to promote employment opportunities and to raise the purchasing power in the hands of the people. With this, the economy may be reversed and chain reaction of demand may push to increase in the employment. But, the government spending can succeed in the attainment of this aim only if it is financed by the way of deficit financing so that additional money created may increase the total spendable funds which in turn push the total demand and employment in the economy.

3. **Deficit Financing and Employment :** As we all know that Keynes advocated deficit financing as an important tool of solving the problem of involuntary unemployment in developing countries in the period of depression or recession. It implies that conditions of unemployment can be removed to a great extent by increasing the effective demand (by increasing the demand of consumption goods and investment goods). The programme of public expenditure financed through deficit financing will increase the purchasing power in the hands of public resulting in raising of the effective demand. As Keynes suggested increase in investment and the successive re-investment of the new income will give rise to the multiplier effect. This will lead to increase in the employment and level of income. In mathematical terms, it can be written as :

$$K = \frac{1}{1 - MPC} = \frac{1}{MPS}$$

Where K = multiplier

MPC = marginal propensity to consume

MPS = Marginal propensity to save

Here, K is directly proportional to marginal propensity to consume and inversely proportional to

marginal propensity to save. Thus, multiplier effect of deficit financing does not hold good especially in the underdeveloped economics. For the proper working of the multiplier in developing countries, the concept is based on two major assumptions :

(a) Existence of excess capacity in industrial as well as agricultural sector.

(b) Supply of working capital is relatively elastic.

In short, Keynesian multiplier principle tends to raise the effective demand rather than effective supply. As the problem of an underdeveloping country is of pushing the effective supply instead of effective demand, therefore, underdeveloped country should keep a constant vigil on deficit financing as it may not prove to be highly inflationary.

**4. Deficit Financing and Distribution of Income :** It is commonly believed that deficit financing tends to produce an unhealthy effect on the distribution of income, and instead of bridging the gap between rich and poor, the gulf of inequality widens continuously. No doubt, it provides incentives to entrepreneurs to produce more and more when their profits tend to rise on account of higher prices. Real income of the wage-earning class declines and rising prices lead to the distribution of wealth in favour of the profiteer class i.e., big businessman. In this way, resorting to heavy deficit financing is severely dangerous for the attainment of social objectives of planning such as equal distribution of income and wealth, improvement in the standard of living.

Deficit financing, is a double-edged sword, It can be good as well as bad. Deficit financing which is designed for development purposes increases net social goods which in turn would lead to the distribution of income and wealth in a most socially desirable manner. But, one must bear in mind that it is difficult to know what will be the effect of deficit financing on prices, income distribution and economic welfare in a modern and dynamic set up. Mostly it depends on the mode of deficit, government's attitude and policies, reactions of the private sector and growth of public sector etc.

**5. Deficit Financing and Economic Growth :** Capital formation is the key-factor in the economic development of a country. So far as the underdeveloped countries are concerned, they are capital-deficit countries. Saving is the basic source of capital formation and under-developed countries have a very low voluntary saving-income ratio. Despite the fact that deficit financing leads to inflation, it can be a significant domestic source of capital formation in a low saving poor country. It may stimulate these resources to mobilise for economic development. It can do so by compelling the economy to save to a greater extent. This saving can take place in a two-fold manner. One as people's consumption may be reduced through a rise in the general price level, secondly as government's use of funds obtained by means of deficit financing for increasing the volume of investment. In this context, Prof. Kurihora has recommended that underdeveloped countries should be encouraged to develop their productive resources as rapidly as possible without any fear of inflation. Similarly, Prof. W.A. Lewis stated, "inflation for the purpose of capital formation in due course is self destructive." Hence Prof. Lewis also favoured the deficit financing.

In fact, when the government of an underdeveloped country makes strenuous efforts to undertake the task of promoting and accelerating economic development, fiscal policy plays an important role. Taxation and other revenue receipts together with borrowings fails to provide sufficient funds for the purpose. Thus, the device of deficit financing is used as a last resort. With the help of this additional purchasing power, the government may acquire resources and put them into investment. This process of diversion of resources from private to governmental use adds to national output without creating inflationary pressures on the economy.

But if the various obstacles like market imperfections and other rigidity of factor supply exist in the economy, then there are chances of rising prices and inflation may creep in; in the later stage it touches to the new heights. Thus, as a result of these factors, there is an increase in total demand on one side and there is not an equivalent increase in production or imports on the other side. Here, inflationary pressures arise.

In short, deficit financing to an extent, may be justified for stimulating rapid economic development but an unlimited deficit tends to create tremendous harms than good due to its inflationary impact. Its disastrous consequences can be watched from the miseries of poor sections of the society. It dislocated the economic development. It undermines the confidence of the people in the stability of the economy. In this way inflation creates shortages of everything and disturbs the inter-sectoral price relationship as well as inter-sectoral terms of trade which further hampers the economic activities. As such, the dangers of deficit financing which lead to inflation is more in underdeveloped economies than in developed countries. Hence, it is correctly estimated that deficit financing is essential as a useful method for financing development activities in backward countries.

**Its role as an instrument of economic development can be judged from the following aspects :**

(a) Whether the deficit financing proves worthwhile for making the best use of un-utilised and surplus resources which exist in the economy.

(b) Whether the deficit financing is helpful in creating new resources.

(c) Whether the deficit financing is helpful to accelerate the rate of economic development.

Deficit financing does not always lead to inflation. If the public expenditure is productive, its inflationary effect will be counteracted. But, it takes time for investment to bear fruit. Therefore, sincere efforts should be made to assess to what extent the economy can absorb a certain amount of deficit financing. Even after this the situation should be kept under constant watch and timely steps be taken if there are indications of the rise of inflationary pressures. There are other fiscal, monetary and physical measures which help to control the prices. In this manner, efficiency of deficit of financing as a tool to promote growth in a backward country, however, depends on factors such as real saving, structure of the economy; social and economic circumstances, and absorbing capacity of the economy. Therefore, deficit financing for economic development can be inflationary but not necessarily always so. The forces which lead to the rise of inflationary forces will depend on the purpose for which it is undertaken, its extent and measure which are adopted to counteract it.

To conclude, deficit financing for financing development activities is not only useful but assumes vital importance for the developing economies and the principle of smoothness with stability should always be preferred to the principle of unbalanced growth.

**6. Deficit Financing and Price Level :** Deficit financing leads to inflationary trend of prices. It is because there is more purchasing power in the hand of the people with the increase in expenditure of the government. In Indian sense, the term deficit financing is the additional purchasing power acquired by the people through government spending due to which prices tend to be pushed up. On the other side, in the Western sense, this is brought about when the borrowing results in the activisation of the idle deposits held in banks by private individuals or the creation of deposits by banks directly undertaking the purchase of government securities or sometimes, the activation of idle hoards of cash held by the public who part with their cash in order to purchase the securities. It should be remembered here that in both sense of the term, it is referred to the increase in expenditure which tends to lead to a rise in the price level.

In the war finance, especially, its effect is very harmful as the expenditures made during this period, are not only in unproductive channels but also causes the diversion of resources to the defence sector. This leads to scarcity of daily needed commodities. Newly created money by banks fails to cope up the need of the community thus causing rise in several price levels. Therefore, an unproductive war finance is unsatisfactory and harmful while development deficit financing helps to stimulate the future production and its effect is neutralised over the period of time due to the expansion of output. It is only possible in a growing economy where there is an increase in the volume of transactions. Demand for money increases under important motives, more public expenditure is made on those state enterprises which have more productivity and yield quick results, accumulations of large foreign exchange reserves. On the contrary, it is more price spiral in the case of excessive capacity, expansion of public sector at the cost of private sector, long gestation period of capital goods industries, government fails to curb prices and non-developmental expenditures etc.

## 10.8 IS DEFICIT FINANCING NECESSARILY INFLATIONARY ?

Now, a legitimate question arises as to whether deficit financing is necessarily inflationary or not? While studying this problem Lekhi provides two arguments one that it is pro-inflationary and other that it is non-inflationary. He discusses both as given below :

### 10.8.1 Deficit Financing is Pro-inflationary :

The school which argues deficit financing as pro-inflationary says that its direct result is an increase in the total money supply with public. Here, credit policy of the Central Bank and other economical banks play vital role. Since, newly created money is utilised for investment expenditures, thus raising purchasing power in the hands of public but the supply of consumer goods does not expand at the similar rate with the result that prices tend to rise. If this trend is kept unchecked, inflationary pressure may spread over to other sectors of the economy. This is also due to the reason that propensity to consume is high in the underdeveloped economies and there are market imperfections on one side and elasticities of food supply are low on the other side.

Furthermore, through deficit financing, aggregate outlay increases. In turn, money income of the general public jumps. Some part of expenditure is made to go in the form of wages, salaries, interest payment, and cost of projects etc., while other income goes to the banking system. On this basis, they create credit more than cash revenues. It also adds to the inflation. Again in an advanced country, there is inflation of cost price push type whereas in under-developed countries, it is of cost-pressure type. In the former case investment is made out of profits, and it is financed by credit creation in the later case. In backward countries, the fiscal as well as monetary steps taken by the government are not much effective as they cannot resist on the increasing demand for government services in the social welfare schemes of the government. In this way, increase in general price level, undoubtedly, hampers the development activities of the government, as not inflationary.

**14.8.1 Deficit Financing not always Inflationary :** Another argument which favours this viewpoint is of the opinion because public sector has emerged as a significant sector in developing economies. In developing countries, deficit financing is essential to provide finance for growing output at stable prices. In this case, it is not inflationary as additional finance has properly been utilised for production purpose and utilised resources have been put into proper channel. The increasing activities in different fields require more and more money which can be met only with deficit financing. Besides, in the absence of deficit financing, it may lead to decline in price, making adverse effects on output and employment. Under these circumstances, therefore, deficit financing is essential for maintaining growth with stability. Prof. W.A. Lewis has rightly observed, “In every economy where economic growth is occurring people need to hold more money, and so the government can create more money without causing prices to rise.”

## 10.9 USES OF DEFICIT FINANCING

Several factors are responsible to explain the situation of continuing deficit in the government budgets since the beginning of the First Five Year Plan, mentioned below :

1. **Non-development Expenditure :** The non-development expenditure like dearness allowances, upgrading of employees' salary scales, wasteful expenditure on the conduct of administration, production of defence equipment etc. are on the increasing side. The government is not in position to cope up the rising expenditure through available resources resulting in deficit financing.
2. **Sources for Development Activities :** Another cause of deficit financing in India is to make easy available resources for the development plans. A high level of outlay laid down in the various five-year plans which could not be met only be taxation, borrowing and, external assistance, on alternative remains except deficit financing.
3. **To Boost the Revenue :** The efforts at raising the tax revenue have always been inadequate due to avoidance of tax on high agricultural increase, tax evasion and heavy expenditure incurred on tax collection etc. This has caused the tax revenue to remain low as a proportion.

The uses of deficit financing are given below :

1. **Best use of Resources :** Deficit financing may be helpful for making the best use of untilised and surplus resources. Moreover, for the development of several projects, it creates the funds.
2. **Helpful to Development Countries :** In the underdeveloped country like India where there is a democratic set up, the Government finds it difficult to create resources through taxation. It is because there is always opposition from the public to increase taxation. Voluntary borrowing have also a limit. For this reason deficit financing remains necessarily alternative to create extra resources.
3. **Additional Purchasing Power :** A small dose of deficit financing helps to increase the money supply and push up demand. This naturally adds to the additional power with the public. Further more, it boosts up the demand for goods and services which in turn leads to increase in production, income and employment.
4. **Helpful despite inflationary Nature :** Generally, it is argued that deficit financing leads to inflation which is against poor masses. But it is not a permanent feature. As soon as the goods start flowing from development price also starts to come down automatically. So, it is helpful even if it is a inflationary nature.

**Self Assessment Question :**

Q. 2 Mention causes of deficit financing ?

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## 10.10 DEFICIT FINANCING AND RELATED PROBLEMS

The expansion or creation of money with the help of deficit financing has ugly side also, explained below :

- **Rise in Prices :** It is truly admitted that deficit financing leads to rise in prices. It is due to the fact that deficit financing increases the supply of money, and therefore, raises the aggregate demand for goods and services. On the other side, the aggregate real output is not rising at the same speed as that of the supply of money, resulting in rise in prices. The experiences of Indian Planning for last 45 years shows that deficit financing has always been accompanied by soaring prices which has touched new heights at every successive plan period. Based on the prices of 1949, there was relative stability in price level in 1st Plan. The wholesale prices have increased by more than 30 per cent in Second Plan with 1952-53 as the base year. It means that the value of money has gone down by about six times than what it was in 1950-51. In other words, presently the worth of rupee is equal to about 8 paise.

It is often argued that inflation provides incentive for private investment. As prices rise, profitability of investment increases that encourages further investment. This is true perhaps in the earlier stages of inflation. As inflation advances and becomes rapid, the increasing, uncertainty in business might damage the will to invest. Therefore, inflation is the most regressive and trouble some to the poor classes.

- **Increase in Money Supply :** Deficit financing results in the direct addition to gross national expenditures. In other words, it results creation of fresh purchasing power in the hands of the government. This addition in money supply in an easy way upsets price level and hurts specially the weaker sections of the society as too much money purchases too few goods.

- **Adequate Speculative Activities :** With the help of deficit financing policy, the Reserve Bank of India and the commercial banks find themselves with larger cash reserves to create larger amounts of credit in the economy. As a result, the Indian market was almost flooded with the surplus of bank money which could be available for any purpose. This has given further rise to the phenomenon of speculation and hoarding of essential commodities.

- **Adverse Effect on Savings :** Another evil of deficit financing is that it is responsible for the adverse effects on saving. As there is rapid rise in price of essential commodities, but not the saving capacity of the public is hampered badly.

- **Less Investment :** No doubt, there are certain fields of investment which receive strong encouragement from inflation. They are like inventory holding, luxury, urban construction and foreign assets. In fact, they are not necessarily the best fields from the angle of development. Rising money incomes greatly favour big producers and not persons with fixed incomes, salaries and wages. Thus, deficit financing leading to inflation has only encouraged those types of investment activities which are not desirable for the development of the Indian Economy. This process has not pushed the investment in the real sense.

- **Unequal Distribution of Income and Wealth :** The inflationary process as a result of deficit financing, is so rapid that it creates unequal distribution of wealth and income. The rich are able to maintain and in fact raise their consumption level while the poors find it difficult and may find it impossible to stay even in the old position. Actually, it is contrary to the canons of progressive taxation. A man who gets his income either from pension or fixed interest on securities, suffers a lot from the full weight of the rise in prices. This type of distribution, in fact, is unfair and dangerous for society.

Truly, the government of an underdeveloped country is always tempted towards the fruits of deficit financing. As it implies, due to the creation of money, sufficient funds are easily available for

development purposes. By this method of creating resources, it is less public uproaring than additional taxation. But at the same time, deficit financing has its own demerits of creating inflationary rise in prices, accentuating the inequalities of wealth and income, discouraging, saving and distoring investment. That is what has actually happened in our country. In every plan period, the amount of deficit financing crossed the limit which was fixed at the start of the plan and was responsible for a number of problems in the economy. Keeping these defects in view, it is sometimes correctly said that it must be adopted within limits.

## 10.11 DEFICIT FINANCING : IS THERE ANY SAFE LIMIT?

Now, question arises what is the safest limit to control the deficit financing? However, it is not easy to lay down any definite formula for determining the safest limit of deficit financing. According to Lekhi

It depends upon some important factors as described below :

1. What are the requirements of the economy? It must be fixed in the light of past experience between money supply and general price level, rate of growth of national product, size of the credit and the power of tolerance of the people regarding rise in prices.
2. *Efforts made by the Government* in respect of mobilisation of resources.
3. Control of prices.

The above stated points are worth while to keep in mind while fixing the limit of deficit financing. Even then, there are other methods which can provide guideline to fix the safe limit as mentioned under:

1. Increase in production of public sector.
2. Reduction in unproductive expenditure.
3. Promotion of Exports and Import substitution.
4. Direct and Indirect control.
5. Restriction on credit.
6. Stability in wage structure.

## 10.12 SUMMARY

Like many other measures of public finance, deficit financing has certain positive effects on social and economic life of the advanced as well as backward countries. These effects, by and large depend on the stage of economic development, the prevailing circumstances and the purpose for which deficit financing is attained. It has been a matter of great controversy that deficit financing has more constructive use in backward countries. It can be an instrument of great use for offsetting depression and for accelerating the pace of economic development at a high rate. But at the same time, it also tends to be inflationary, if there are imperfections and rigidities in the economy, it turns out to be very dangerous. This is the reason that it is called bad master but a good servant. Under these circumstances, it needs proper handling specially in the underdeveloped countries. Moreover, it must be kept within limits. It should be accompanied by anti-inflationary measures and its effects should be watched carefully.

## 10.13 REFERENCES

Lekhi, R.K. and Singh, Joginder (2015) – *Public Finance*, Kalyani Publishers, New Delhi.

## 10.14 FURTHER READINGS


- Musgrave and Musgrave (1996). *Public Finance in Theory and Practice.* Tata McGraw Hill Pvt. Ltd.


## 10.15 MODEL QUESTIONS

1. What is Deficit Financing? Under what situations can it be justified?
2. Explain the usefulness and limitations of Deficit Financing for promoting economic development.
3. What measures would you suggest to check the inflationary pressures arising out of Deficit Financing?
4. 'Deficit Financing can be effective tool of development provided it has no inflationary biases. Comment.
5. How far Deficit Financing has been used in India?

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**Lesson - 11**

# PUBLIC EXPENDITURE: CONCEPT & THEORIES

**Structure**


11.0 Objectives

11.1 Introduction

11.2 What is Public Expenditures?

11.3 Public and Private Expenditure; A Comparison

11.4 Role of Public Expenditure in UDCs

11.5 Laws of Public Expenditure

 11.5.1 Wagner's Law of Increasing State Activities

 11.5.2 Wiseman-Peacock Hypothesis

11.6 Cannons of Public Expenditure

 11.6.1 Cannons of Benefit

 11.6.2 Cannons of Economy

 11.6.3 Cannons of Surplus

 11.6.4 Cannons of Sanction

 11.6.5 Other Cannons

 (Elasticity, Equitable, Distribution, Productivity, Neutrality, Certainty, Performance)

11.7 Growth of Public Expenditure : Reasons

11.8 Summary

11.9 Glossary

11.10 Reference

11.11 Further Readings

11.12 Model Question


## 11.0 OBJECTIVES

After going through this lesson, you shall be able to :

- explain public expenditure
- distinguish between private and public expenditure
- discuss the objectives (short term & long term) of public expenditure in UDCs
- explain Wagner's law of increasing state activity

- describe Wise-man Peacock hypothesis of public expenditure
- delineate the Cannons of public expenditure

## 11.1 INTRODUCTION

After studying two units of syllabus on theoretical constructs, we are entering into practical issues of public Finance. This lesson deals with public expenditure-its meaning, difference with private expenditure, its objectives in UDCs, two famous laws-Wagner's law and Wiseman-Peacock Hypothesis, and cannons of public expenditure.

## 11.2 WHAT IS PUBLIC EXPENDITURE?

Public expenditure refers to the expenses which a government incurs for (i) its own maintenance, (ii) the society and the economy, and (iii) helping other countries. In practice, however, with expanding State activities, it is becoming increasingly difficult to separate the portion of public expenditure meant for the maintenance of the government itself from the total.

Historically, public expenditure has recorded a continuous increase over time in almost every country. Though traditional thinking and philosophy did not favour this trend because it rated market mechanism as a better guide for the working of the economy and allocation of its resources. It was argued that each economic unit was the best judge of its own economic interests and the government should not try to decide on behalf of others. Furthermore, while a private economic unit is guided by its own economic interests, the public sector has no such motivation. Rather the state can not ignore problems of economic growth and social injustice. It cannot remain a silent spectator to the miseries of the people. This resulted in the acceptance of several versions of socialist and welfare philosophy. Let's understand how private and public expenditure differ from each other and in what respect they are similar.

## 11.3 PUBLIC AND PRIVATE EXPENDITURE; A COMPARISON

Many factors can be listed in order to draw **similarities** between the public and private expenditures. Both private units and public authorities try to maximize returns per unit of expenditure (the returns being the objectives to be achieved). Any shortfall on this front will be on account of inefficiency, uncertainty, lack of foresight and similar other causes. Another point of similarity between private and public expenditure is an element of flexibility, though it is generally more in the case of public expenditure. Both private economic units and public authorities take a collective view of the income, expenditure and the possibilities of adjustments in each. While an individual has to make a choice between an effort to earn and leisure, a firm chooses between the cost and earning and the public authorities compare effects of additional revenue with those of extra expenditure. It must also be remembered that in each case there can be more than one way of raising additional income. The authorities, for example, can plan to raise the additional tax or non-tax revenue or borrowing or even raising taxation in various forms. Therefore, there arises problem of efficient and integrated management of finances. They are related to the alternative ways in which finances can be raised, the efforts needed to raise finances, the effects of such revenue efforts and the corresponding benefits of the expenditure which are to be incurred. It is also obvious that depending upon circumstances prevailing at the time, the net equilibrating solution will differ. While in some cases a larger tax and expenditure level would be desirable, in others the amount indicated will be smaller. Similarly, in the case of private finance, we have different levels at which the solutions will be found.

However, while private and public expenditures are similar in their overall and complex ramifications, the ***dissimilarities*** between them are also quite glaring. The first such dissimilarity is the objective with which the expenditure is incurred. In the case of an individual economic unit, generally an exchange relationship determines the mode, pattern and volume of expenditure. When we explain the

behaviours of public and private expenditures in technical terms, the consumer as an individual equates the marginal utility of the good (or service) purchased with the disutility of expenditure; and a commercial economic unit compares private marginal returns from an expenditure with the amount spent. Public authorities, however, cannot and do not always adopt a commercial attitude towards their expenditure plans. They have to consider social benefits generated in the process of their expenditure activities. And, in quite a few cases these benefits are vague and immeasurable. The State has to impute social valuation to these benefits and decide whether it is worthwhile undertaking these expenditures or not. Also, certain State expenditures are directed at bringing about social and economic justice. The benefits of such State expenditures cannot be evaluated directly.

Keeping in view the fact that the State is the guardian of the social welfare and economic health of the society, provision for many public services is not decided on the basis of their cost-effectiveness. Moreover, an individual has a limited horizon covering only a foreseeable future. The State, on the other hand, takes a paternalistic view. For this reason, the State may adopt even a policy of permanent budgetary deficit. A private economic unit cannot do so. The objectives of public expenditure are far wider. Lets study the objectives in next section.

**Self Assessment Question**

Q. 1 Differentiate between Public and Private expenditure.

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## 11.4 ROLE OF PUBLIC EXPENDITURE IN UNDERDEVELOPED COUNTRIES

Public expenditure has been increasingly resorted to in modern times with the aim of influencing the economic life of a nation particularly of that of backward underdeveloped countries. These countries are the victims of chronic unemployment and market imperfections. According to Ragnar Nurkse - the most significant cause of economic backwardness is the existence of the vicious circle of poverty in the poor countries as they lack sufficient resources for promoting development. Inevitably, the role of public expenditure becomes requisite in such economies. In fact, the theory of public expenditure in a backward country ought to be the theory of investment. Therefore, investment expenditure programmes should be planned in such a manner which may help to achieve the long-term and short-term objectives of economic development. Hence the objective of public expenditure can be classified as

(a) Long-Term objectives

(b) Short-Term objectives.

**I. Short- Term Objectives of Public Expenditure**

Investment expenditure in a country should not neglect the immediate needs of the economy during the course of preparing long-term development strategies on the basis of perspective planning. Investment needs, otherwise neglected have serious repercussions for the country.

For the smooth working, there are three fundamental factors mentioned below :

Improvement in the productivity of agriculture sector. (ii) Supply of essential consumer goods to curb inflationary tendencies in the economy. (iii) Creation of employment opportunities to absorb surplus population and to avoid unnecessary wastage of human power.

Actually, public expenditure in an underdeveloped country should play dual role. In other words, it should prepare for structural change and fulfill immediate needs of the economy by making proper allocation of existing resources.

To get the desired results, short-run objectives of public expenditure should aim at :

1. Proper allocation of resources
2. Fixation of priorities
3. Removal of inequalities in income and wealth
4. Balanced regional development.
5. To check concentration and monopolistic practices.
6. Generation of employment opportunities.
7. Social Justice.

**II. Long-Term Objectives of Public Expenditure**

The aim of long-term objectives of public expenditure is to achieve more rapid rate of output in the long period. Therefore, it aims at

**(i) To Establish Basic and Key Goods Industries :** In view of long-term perspective, public expenditure is made to establish basic and key capital goods industries which may impart a momentum to the development and create sufficient saving for future investment. This would in turn reduce the dependence of underdeveloped countries on foreign countries in respect of basic and key requirements of industrial sector.

**(ii) To Create Social Overheads :** The underdeveloped countries through Public expenditure make efforts to create infrastructure like railways, roads, dams, shipping, telephones, banking facilities, education institutions and health facilities etc. These social overheads are considered the basic foundations of economic growth.

**(iii) To Attain Self-Sustained Growth :** Another significant objective of public expenditure in underdeveloped countries is to generate self-sufficient and self-sustained growth. This needs to bring about structural changes in the economy. This big push in the economy is provided through making public expenditure. Therefore, public expenditure assumes this responsibility to push the economy to reach the stage of self-generating growth.

Hence the responsibility of the public investment expenditure lies with the Government to take steps to break the vicious circle of poverty and provide momentum to the economy to grow itself. Public expenditure, thus undoubtedly, plays prominent role in lifting up the economy from the state of backwardness and poverty and in attaining self-sustained growth through its monetary and fiscal measures.

## 11.5 LAWS OF PUBLIC EXPENDITURE : WAGNER AND WISEMAN-PEACOCK

There are two important and well known theories of increasing Public expenditure : Wagner's Law and Law by Wisemen and Peacock.

### 11.5.1 Wagner's Law of Increasing State Activities

**Introducation :**

Adolph Wagner (1835-1917) was a German economist who based his *Law of increasing State Activities* on historical facts, primarily of Germany.

**Explanation :** According to Wagner, there are inherent tendencies for the activities of different layers of a government (such as central and state governments) to increase both intensively and extensively. There is a functional relationship between the growth of an economy and government activities with the result that the government sector grows faster than the economy.

This has been shown in Fig. 9.1, where real per capita income is measured on X-axis and real per capita output of public goods is shown on Y-axis.

In this figure, public sector maintains constant proportion of total production as shown along the line $A^1$. It indicats that $\frac{PG_a}{Y_a} = \frac{PG_o}{Y_o}$ i.e. proportion of total resources devoted to the output of public goods remains same over time.

Where *o* is base year

*a* is current year

And y = per capita Income of respective year

PG = per capita Output of public goods

Thus PG/y = proportion of total resources devoted to the output of public goods. The line $A^1$ has been taken as the reference point for Wagner's Law.

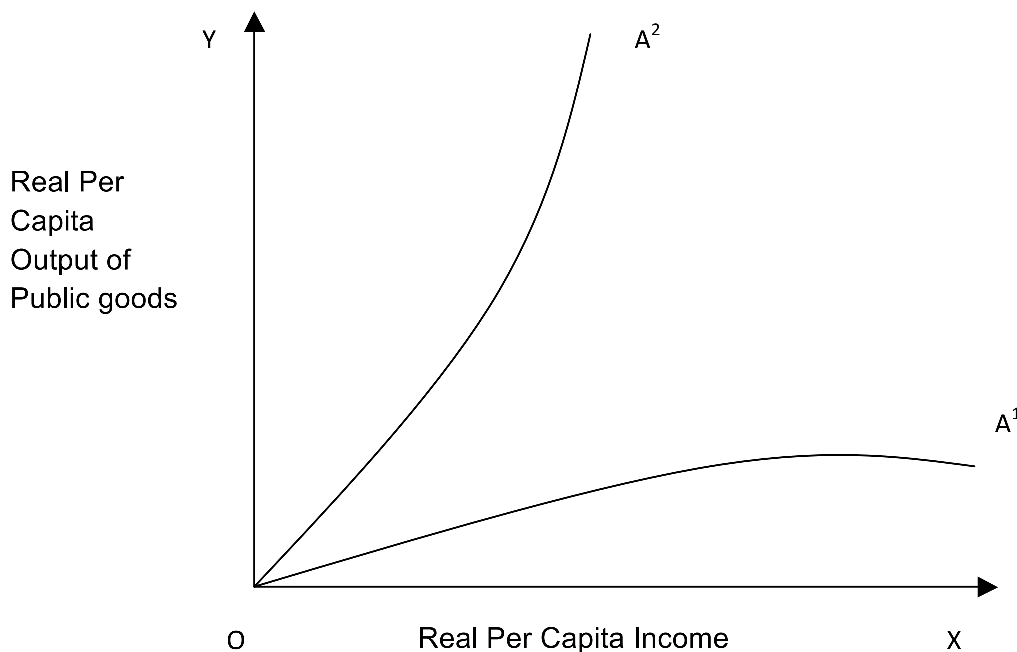



**Fig. 11.1**

Where as line $A^2$ indicates $\frac{PG_a}{Y_a} > \frac{PG_o}{Y_o}$

It shows that the proportion of total resources devoted to the output of public goods expands in the society over time.

From the original version of this theory it is not clear whether Wagner was referring to an increase in

(a) absolute level of public expenditure,

(b) the ratio of government expenditure to GNP, or

(c) proportion of public sector in the total economy.

Musgrave believes that Wagner was thinking of (c) above. F.S. Nitti not only supported Wagner's thesis but also concluded with empirical evidence that it was equally applicable to several other govermnents which differed widely from each other. All kinds of governments, irrespective of their levels (say, the central or state governments), intentions (peaceful or warlike), and size, etc., had exhibited the same tendency of increasing public expenditure.

**Reasons :**

A number of reasons can be enumerated for this inherent long-term tendency recorded in history.

*First,* there has been an expansion in the traditional functions of the State. Defence has become increasingly more expensive over time. Within the country, administrative set up has kept increasing both in coverageand intensity. The government machinery had to be manned by experts in their fields. With the progress of society, administration of the government, and its services had to become increasingly more extensive, cumbersome and expensive so as to retain efficiency.

*Second,* the State activities have been increasing in their coverage. Traditionally they were limited to only defence, justice, law and order, maintenance of the State and social overheads. But with growing awareness of its responsibilities to the society, the government started expanding its activities in hitherto unexplored field of socio-economic welfare. These measures included efforts to enrich cultural life of the society and provision of social security to the people (such as old age pensions and so on). Subsidies for and direct provision of various *merit goods* also registered an increase. Most governments also took active steps to ensure distributive justice by reducing income and wealth inequalities.

*Third,* there had been an increasing need to provide and expand the sphere of *public goods*. The State tried to shift the composition of national produce in favour of public goods and this, in turn, necessitated an expansion of investment activity of the government.

Wagner's Law was based upon historical facts. *It did not reveal the inner compulsions under which a government has to increase its activities and public expenditure as time passes.* It was applicable only to modern progressive governments which were interested in expanding public sector of the economy for its overall benefit. This general tendency of expanding State activities had a definite long-term trend, though in the short-run, financial difficulties could come in its way. "But in the long-run the desire for development of a progressive people will always overcome these financial difficulties".

Wagner seemingly referred to long-term trend rather than short-term changes in public expenditure. Moreover, he was not concerned with the mechanism of increase in puiblic expenditure. Since his study is based on the historical experience, the precise quantitative relationship between the extent of increase in public expenditure and time taken by it was not fixed in any logical or functional manner. His contention that public expenditure had been increasing over time, could not be used to

predict its rate of increase in future. Actually, it is consistent with Wagner's law to state that in future the State expenditure would increase at a rate slower than the national income though, factually speaking, it had increased at a faster rate in the past. Thus, in the initial stages of economic growth, the State finds that it has to expand its activities quite fast in several fields like education, health, civic amenities, transport, communications, and so on. But when the initial deficiency is removed, then the increase in State activities may be slowed down.

*Additional Factors* which contribute to the tendency of increasing public expenditure relate to a growing role of the State in ever-increasing socio-economic complexities of modern society.

(i) Musgrave and Musgrave emphasise on a growing complementarity between public and private consumer and capital goods so that with an increase in per capita income, demand for public services also increases with a corresponding growth in public expenditure. This point is further elaborated later in this chapter.

(ii) Many societies are experiencing a *growing population* which becomes a major contributory factor in the growth of public expenditure. The sheer scale of state services has to increase to keep pace with population growth, including, for example, more schools, hospitals and police etc.

(iii) Most countries have registered increasing *urbanisation*. Existing cities grow and new ones come up. Urbanisation implies a much larger per capita expenditure on civic amenities. It necessitates a much larger supply of incidental services like those connected with traffic, roads and so.

(iv) *Prices* have a secular tendency to go up. This also adds to public expenditure even if the scale of state services remains unchanged.

(v) The size and nature of public services necessitates an ever-increasing specialisation. The quality of the services improves, both as a historical fact as also due to circumstantial compulsions. Better quality services and higher qualified administrators, technicians etc., imply a higher cost of providing public services. Also, the government has to purchase a number of goods and services for its own maintenance. With rising prices, expenditure on them also goes up.

(vi) A modern government considers it apart of its duty to protect the economy from the "failures" of market mechanism. Accordingly, anti-cyclical and other regulatory measures are adopted. Efforts are made to *reduce the income and wealth inequalities* and bring about social and economic justice which, in turn, add to public expenditure.

(vii) Modern governments have shown a tendency to run into debt and this leads to a subsequent increase in public expenditure in the form of increasing cost of *debt servicing* and repayment of the loans.

(viii) Popularity of the philosophy of planning and economic growth as also increasing government activities in the areas of capital accumulation and economic growth have also contributed to the growth of public sector.

(ix) There is an inherent tendency of vested interests to develop which demand an increase in public expenditure for their own benefit. For this reason, a variety of *subsidies and other avoidable expenditures* inflate the public budget.

(x) It is claimed that government bureaucracy has an inherent tendency to expand irrespective of the size and nature of public services provided by it.

(xi) Recent investigations have brought into focus productivity and efficiency dimensions of government organs and public undertakings as also the manner in which these dimensions push up public expenditure. Specific mention may be made of the concepts of "productivity lag" advanced by Allan Peacock and Baumol's Disease. According to these concepts, public sector is less efficient and productive than the private one, and tends to be more labour-intensive (or over-staffed). Similarly, an element of avoidable inefficiency and therefore cost (termed X-inefficiency) creeps in due to poor supervision, non-fixation of responsibility, non-check on output of individual employees and non-quantification of government services.

(xii) At the same time, there is a myth that the individuals can voluntarily get together to resolve market deficiencies without government intervention. It is known as Coase Fallacy. The myth is explained by Fundamental Non-Decentralizability Theorem expounded by B. Greenland and J.Stiglitz.

**Limitations :**

Wagner's model has an important analytical limitation which can be removed in an expanded version. A government is not a monolithic entity. It comprises a number of organs and associated institutions. Households and business units in the private sector also do not observe government activities passively. Instead, they respond to them more actively. Thus, the government decision-making has become a complex phenomenon and has multifarious tendencies to increase public expenditure.

**Relevances in present Itmes**

We may add that modern governments have found new weapons whereby to increase their expenditure even without collecting more taxes. They now own *public undertakings* which can be a source of revenue to them. But more important than that is *their capacity and willingness to resort to deficit financing*. Even in advanced countries deficit financing has become a common occurrence. The public opinion is not strong enough to check this sort of policy even though it has disastrous inflationary effects.

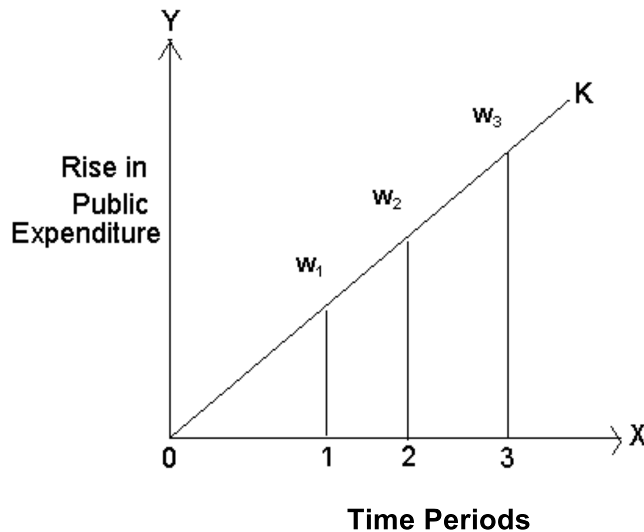
### 11.5.2 Wiseman-Peacock Hypothesis

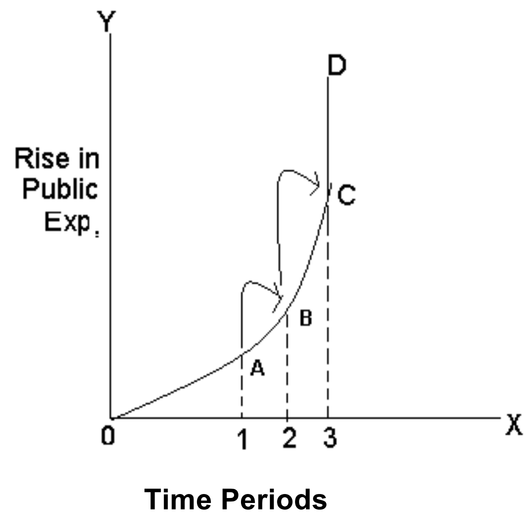
**Introduction**

The second thesis dealing with the growth of public expenditure was put forth by Wiseman and Peacock in their study of public expenditure in UK for the period 1890-1955. *The main thesis of the authors is that public expenditure does not increase in a smooth and continuous manner, but in jerks or step like fashion*. They observed that most of the upward steps in taxing and spending took place during period of major social disturbances. While earlier, due to an insufficient pressure for public expenditure, the revenue constraint was dominating and restraining an expansion in public expenditure, now under changed requirements such a restraint gives way. The public expenditure increases and makes the inadequacy of the present revenue quite clear to every one.

**Explanations**

The study conducted by Wiseman and Peacock shows that public expenditure, rather than maintaining a smooth continuous rate of increase, jumps upward at intervals due to recurrence of abnormal situations. Therefore rising public expenditure curve has many kinds as distinguished from Wagner's law of continuous change. It is shown in Fig. 11.2(b) where irregular kinky rise in public expenditure occurs at points A, B, C in the periods 1, 2, 3 respectively.




**Time Periods**

**11.2 (a)** Wagnarian Increase in Public Expenditure

**Time Periods**

**11.2 (b)** Kinky Increase Under Wiseman-Peacock Hypothesis

**Fig. 11.2**

As shown in Fig 11.2 (a) the public expenditure maintains a smooth rate of increase shown by $w_1$, $w_2$ & $w_3$ for the periods 1, 2, 3 respectively; while the fig. 11.2(b) shows increasing rate of increase reflected by kinks A, B and C for the periods 1, 2, 3 respectively.

This hypothesis is based on three separate effects :

(a) Displacement effect

(b) Inspection effect

(c) Concentration effect.

- The **displacement effect** is shown in Fig 11.2 (b). The kinky movement from A to B and from B to C, due to emergence of abnormal need for raising public expenditure, shows the displacement effect.
- The movement from the older level of expenditure and taxation to a new and higher level is the ***displacement effect***.
- After the social disturbances has ended the newly emerged level of tax tolerance makes the society willing to support a higher level of public expenditure since the society realises that they are capable of carrying a heavier tax burden then it previously was. The inadequacy of the revenue as compared with the required public expenditure creates an **inspection effect.**

The government and the people review the revenue position and the need to find a solution of the important problems that have come up and agree to the required adjustments to finance the increased expenditure. They attain a new level of *tax tolerance*. As they are ready to tolerate a greater burden of taxation, the general level of expenditure and revenue goes up. In this way, the public expenditure and revenue get stabilised at a new level till another disturbance occurs to cause a displacement effect. *Thus each major disturbance leads to the government assuming a larger proportion of the total national economic activity. In other words, there is a concentration effect*. The concentration effect also refers to the apparent tendency for central government economic activity to

grow faster than that of the state and local level governments. British data are consistent with this hypothesis, but its application to other countries needs verification. Moreover, this aspect of concentration effect is also closely connected with the political set up of the country.

**Relevance**

Though Wiseman Peacock hypothesis looks quite convincing, it should be kept in mind that they are emphasising the recurrence of abnormal situations which cause sizeable jumps in public. expenditure and revenue. In all fairness to the historical facts, we must not forget that on account of advancement of the economy and the structural changes therein, there are constant and regular increments in public expenditure and revenue. Public expenditure has a tendency to grow on account of a systematic expansion of the public activities as also an increase in their intensity and quality. Increasing population, urbanisation and an ever-increasing awareness of the civic rights on the part of the public, coupled with an increasing awareness of its duties on the part of the state, leads to an upward movement of public expenditure. To an extent public expenditure gets financed by ever-increasing revenue which is made possible through the expansion and structural changes in the economy. These days, in underdeveloped countries like India, the state is deliberately trying to increase its activities and makes an effort to finance those activities through various tax efforts. Even in developed countries, the State finds that it has to perform an increasing regulatory duty to protect the economy against instability and excessive inequalities of income and wealth. *Thus, Wiseman Peacock hypothesis is still a description of a particular tendency and does not isolate all the relevant causes at work.*

It must be emphasized that apart from various factors like population growth, defence expenditure, urbanisation, rising prices etc., which by themselves push up public expenditure, an important additional contributory force is the failure of market mechanism in achieving various 'socio-economic objectives of the country. Inherent deficiencies of market mechanism make the economy a prey of economic instability, income and wealth inequalities, defective patterns of consumption, employment and investment and so on. In a number of cases, the market mechanism is not able to pull the economy out of its vicious circle of poverty and launch it on a path of secular and rapid economic growth. Therefore, the government is forced to increase its field of activities with a corresponding increase in public expenditure.

**Self Assessment Question**

Q. 2 What is the basic difference between Wagne's hypotheses and Wise-man Peacock hypothesis?

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________________________________________________________________________
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## 11.6 CANONS OF PUBLIC EXPENDITURE

The canons or principles of public expenditure are the fundamental rules which should govern the expenditure policy of the state authority. Some economists like Prof. A.G. Bucher attempted to lay down certain guidelines for public expenditure to be followed by the concerned government. Following principles should be followed:

(a) It should promote the welfare of the society.

(b) The funds should be properly utilised for conducting social welfares chances.

In fact, the principles of public expenditure determine the efficiency and propriety of the expenditure itself. Prof. Shirras has made the unique contribution in suggesting the canons of public expenditure. These canons are broadly described below :

**11.6.1 Canon of Benefit :**

This law states the public expenditure should be planned in such a way that it results in achievement of maximum social advantage. In simple words, public money should not be utilised for the benefit of an individual or particular group rather it should equitably confer benefits on the entire society. Thus, this canon is synonymous with the principle of maximum aggregate benefit.

In the words of Prof. Shirras, *"Other things being equal, expenditure should bring with it important social advantages such as increased production, the preservation of social whole against external attack and internal disorder and as far as possible a reduction in the inequalities of income. In short, public funds must be spent in those directions most conducive to the public interest i.e. maximum utility is to be attained in public expenditure.*

*To quote Huge Dalhon , "Public expenditure in every direction must be carried just so far that the advantage to the community of a further small increase in any direction is just balanced by the disadvantage of a corresponding small increase in taxation and in receipts from any other source of public income. This gives the ideal of public expenditure and public income".*

This principle of social benefit in the theory of public finance is similar to the equi-marginal utility in the theory of consumer behaviour. Implying thereby that public authorities should distribute its resources in such a manner that marginal utility from all uses should be equal. The canon of benefit has no substitute or alternative. However, it is difficult to measure the benefit from some items of public expenditure. In short, the canon of benefit aims at the improvement of production and distribution system in the country.

**11.6.2 Canon of Economy :**

The canon of economy means the state should be economical in spending money. Public expenditure must be productive and efficient. So the state should not spend more than the necessary amount on any item of expenditure. It should also develop the productive powers of the community as much as possible. This is a positive aspect of the economy. However, state should give first consideration to the present and also accord proper significance to the future.

Prof. Shirras Comments, "*Economy means protecting the interests of tax-payers not merely in effecting economies in expenditure, but in developing revenue."*

So, the expenditure incurred by the state should help to expand its revenue also.

**11.6.3 Canon of Surplus :**

The canon of surplus means that governments should avoid deficits and should aim at surplus in the budget. They should not spend more than what they earn just as an individual does. To quote Prof. Shirras,

*"Public authorities must earn their living and pay their way like ordinary citizens. Balanced budgets must, as in the private expenditure, be the order of the day. Annual expenditure must be balanced without the creation of fresh credits unrepresented by the new assets."*

This canon means cutting one's coat according to one's cloth. Thus, public authorities must have sufficient revenues not to meet their current expenditure but must have surplus for unforeseen

future. It implies that the state may borrow money but it should have enough revenue or capability to repay the loans and debts with in stipulated time.

In the modern times, the balanced budget generally not considered good. Balanced budget is desirable when there is full-employment and price stability. In the inflationary condition, a surplus budget is desirable because it will reduce the excessive purchasing power in the hands of public. On the other hand, deficit budget is desirable in times of depression because it will increase the purchasing power of the people and will increase the effective aggregate demand and brings equilibrium between demand and the current output. But the canon of surplus has lost the importance in present times.

**11.6.4 Canon of Sanction :**

The canon of sanction refers to the proper procedure of formulating the policy of public expenditure. It implies to avoid arbitrariness and influence of certain vested interests in the matter of public expenditure. It emphasises that the spending authority should obtain sanction from a higher authority established for the purpose. In simple words, this canon asserts that no public expenditure should be incurred without proper sanction. This does not imply that every government body has no liberty of spending expenditure to a certain limit, but every expenditure beyond that limit should be incurred after obtaining the sanction of proper authority. The canon of sanction also includes that the spending authority should and assure that the sanctioned money is properly utilised. Public accounts should always be audited at the end of financial year. This helps to control unwise and arbitrary spending of public money.

**11.6.5 Other Canons :**

Besides, the above mentioned canons of public expenditure, few canons of public expenditure have been suggested by some other economists. They are canons of elasticity, productivity and equitable distribution as discussed below :

**(i) Canon of Elasticity :** The canon of elasticity refers to the flexibility in the expenditure policy of government i.e. it should be possible to change the size and the direction of public expenditure according to the requirements of the country. Therefore, expenditure policy of the government must be elastic rather than rigid. In other words, the public expenditure should be so formulated that the diversion of resources can be carried out in emergency and it may not upset usual process of financing other development programme.

**(ii) Canon of Equitable Distribution :** It implies that public expenditure should be incurred in such a manner that equalities in the distribution of wealth and income are ensured. This canon is more important for those countries where glaring inequalities of income and wealth are prevailing. This can be achieved by introducing more benefit schemes for the poor sections of the society in the form of providing facilities of medical, education, housing and old age pension etc.

**(iii) Canon of Productivity :** This canon implies that the public expenditure policy should be such as to encourage the production in the country. It means that the major part of the country's public expenditure should be allocated for production and development purposes. This canon attained the importance since the wave of development programmes started specially in the underdeveloped countries. Thus, it based on the goal of maximum output and employment.

**(iv) Canon of Neutrality :** As the name indicates, this canon signifies that public expenditure should not adversely affect the economic set up like production, distribution and exchange. Public expenditure should result in increased production and productivity, reduced inequality of income and wealth and increased economic activity. By 'neutrality' we only mean that public expenditure should not worsen the production-distribution-exchange relationship.

**(v) Canon of Certainty :** This canon refers that public authorities should exactly know the purpose and extent of public expenditure. The spending unit should be certain as what to be spent for and how much spend. This requires a proper expenditure plan well thought out before hand. The canon of certainty is followed through the preparation of budget. The budget provides the detailed amount and purpose of expenditure for the whole financial year.

**(vi) Canon of Performance :** This canon implies the need for performance budgeting. When public expenditure is made for the achievement of a particular purpose, it is essential that a review of result made at times and follow-up measures pursued when necessary. A review of the performance will always keep the spending authority vigilant to the purpose of expenditure.

## 11.7 GROWTH OF PUBLIC EXPENDITURE : REASONS

Public expenditure has increased manifold in the recent past and it continues to be exhibiting an increasing trend in almost all countries of the world. To quote C.C. Plehm,

*"Public expenditure grows because, and as, public activities increase. This increase is both extensive and intensive. Government in every branch central, intermediate and local are constantly assuming new work or duties and are constantly performing the older functions and in turn, newer ones also, on an ever larger scale."*

Therefore, statistics of public expenditure by modern welfare governments demonstrate such persistent increase, so that Adolph Wagner's law of increasing expansion of state activities proved empirically. Generally, following factor are responsible for increasing volume of expenditure :

**(i)** ***Welfare States :*** In the modern times, states are the welfare states. They have the aim of promoting the economic, political and social life of the people. The welfare aspect of government activity is described as the pressure for social progress by Wagner. According to Wagner's hypothesis, the pressure of social reform may be regarded as the root cause of the relative growth of the public expenditure today. In short, these functions have necessitated the adoption of the strategy of planned economic development which involves huge amount of expenditure.

The state undertake many welfare functions like education, public health etc. Be it capitalistic or communist government. State intervention is increasing through legislative and administrative measures to enhance production and improving distribution system. Keynes was of the opinion that state must intervene in the economic system of the country to secure stabilisation in advanced countries and acceleration of rate of growth in underdeveloped countries. In present times the state has assumed new functions: social insurance, unemployment reliefs, cheap medical facilities, old age pensions, housing facilities etc. Especially in underdeveloped countries such as India, the state expenditure is rising very fast in order to reduce the social inequalities.

**(ii)** ***Defence Needs :*** Due to rapid growth of the science and technology in the sphere of nuclear weapons, there is a rave threat of foreign attacks. The political situation all over the world is insecure. If one country strengthens its defence forces, the other countries are forced to take similar steps in their self-defence in anticipation. The modern nuclear weapons, training and planning or army is a very costly affair and increases the burden of public expenditure.

In India, the defence expenditure includes the maintenance of army, air force, navy, development of military art and practice. It has increased manifold since Chinese aggression in 1962. Obviously, this has led to a huge increase in public expenditure.

**(iii)** ***Agriculture Development :*** In developing countries, the development of agriculture is the key factor of the progress of the economy. The inter-relationship between agriculture and non-agriculture sector makes this sector more important.

The expansion of agricultural sector provides a stimulus to industrialisation. On the other hand, industrial sector manufactures modern tools and implements for it which in turn are responsible for the rise in agriculture productivity. Therefore, the governments are spending huge amounts for the development of agriculture sector especially in India. Therefore the government provides loans, subsidised on fertilizers and pesticides on minimum prices and funds for agricultural research and conservation programmes.

**(iv)** ***Rural Development :*** The government has to spend huge amount for the development of rural folk in the developing countries like India where majority of population lives in villages. It has to undertake schemes like community development projects and other social measures. In India, many such schemes have been introduced to eradicate the poverty. They are IDRP, DPAP, NREP, TRYSEM, CSRE, DDP, SFDA/MFALA etc. Undoubtedly, they have raised the expenditure of the government manifold.

**(v)** ***Industrial Development :*** After world depression, government took active participation to promote an industrial development. In addition to it, government also took measures to control monopolies and to provide consumer goods and services at reduced cost. This led naturally to a greater share for public expenditures.

**(vi)** ***Rising Population :*** With the growth of population the state has to bear additional housing and sanitation etc. The government has also to check the growth of the population and to spend huge amount for the family planning programme.

**(vii)** ***Urbanisation and Civil Amenities :*** With the spread of urbanisation, there has been growth of public expenditure on civil administration mainly due to rise of population in these areas. Expenses on water supply, electricity, transport, maintenance of roads, educational institutions, traffic controls, public health have increased tremendously in these areas. Hence, increase in expenditure on civic amenities leads to an upward increase in public expenditure.

**(viii)** ***Democratic and Socialistic Structure of the Government :*** The growth of democracy and socialism has been responsible for the increase of public expenditure to a great extent. A democratic form of government is more expensive than the other forms of government. For instance, democracy in India has become a costly affair. Expenditure on election, bye-election and administrative set up is increasing. The ruling party has to appear the public by making excessive expenditures on new policies. Furthermore, they have to fulfill their promises made in the manifesto at the time of election. Similarly, gradual shift of thinking towards the state governments have to shoulder larger responsibilities to perform social activities. Public sector and nationalisation are equally responsible to push the public expenses to a larger extent.

**(ix)** ***Social Progress :*** With the motto of Socialistic Pattern of Society, the state has undertaken a lot of new functions like the upliftment of deprived sections and economically weaker sections of the society. The government has set up Scheduled Caste Welfare Corporation Backward Classes Development Board and other similar organisations for the welfare of these sections. The government grants interest-free loans, subsidised ration and other facilities resulting in social progress to remove disparities.

**(x)** ***Business Fluctuations :*** As fiscal policy has been recognised as a controlling measure during cyclical fluctuations, the government spends huge public expenditure in the period of depression or recession. In a developed economy, the policy is designed to maintain full employment. In a less

developed economy the theory of functional finance requires the growth of public expenditure to attain the full employment. During the financial crisis of USA which occurred in 2008, the US Government added out subsidies to tackle the situation.

**(xi)** ***Growth of Transport and Communication :*** The growth of transport and communication is another factor which has contributed to increase the expenditure. Government is supposed to run these services even at no profit no loss basis. The governments in backward and underdeveloped countries has to make huge investment on railway, road and communication to cater to the needs of general public.

**(xii)** ***Adoption of Planning :*** In the modern world, all popular governments have adopted economic planning in one form or the other for the development of the country. In a developing country when public sector is expanding its role, the public expenditure shows an increasing trend. In India, the development expenditure in 1951-52 was Rs. 375 crores. It rose to 1183036 by 2009-10.

**(xiii)** ***Expansion of Traditional Functions :*** In ancient times, the state had only limited functions of justice, internal security and external security. But with the passage of time, there has been tremendous expansion of these functions as states are now welfare states. For instance, in India, there has been an increase in number of courts, police network consisting of sophisticated technology, nuclear weapons for external safety resulting in increase in the expansion of these functions by the state.

**(xiv)** ***Change in Expectations from Government :*** Earlier, the governments were feared as a source of arbitrary power. Today it is generally believed that a fair deal to the common man can be given only by the government. Rich and abundant life can be achieved only by relying on the government. It is mainly due to following factors :

(a) Under laissez faire set up existence of Monopolistic forces compel the government to step into balance such inequalities and keep the economy in perfect balance.

(b) Political and economic problems have become more complex which warrants greater role by the government especially in the field of education, health, sanitation, housing, policing and internal law and order problems etc.

(c) Technical changes have increased interdependence.

**(xv)** In addition, another factor which has contributed to rise in public expenditure is the **rise of price level** all over the world since Second World War. Rise in the price level has two important effects on the government : (i) the government has to pay higher prices for all goods and services which it has to buy; and (ii) it has to find larger financial resources to meet its growing expenditure.

**(xvi)** The **increase in national income** is also responsible for raising the public expenditure as it leads towards economic development of a country. As a result, public revenue increase because of increased taxation income from which in turn stimulates the public expenditure.(or leads to increase in public expenditure).

## 11.8 SUMMARY

In this chapter we have studied that all welfare economies incur expenditure for the general welfare of the public, for maintaining law and order in the economy and for defence purposes in the main. Thus all types of expenditure fall under the category of public expenditure. It altogether different from private/expenditure. Wagner's Law and Wiseman-Peacock Hypothesis provide theoretical

exposition of the forces that have led to increase in public expenditure of all the welfare economies in post World War II period. There are various reasons which can be attributed to increase in public expenditure like increasing functions of the state, increase in national income or population and prices etc. There are certain rules which need to be followed for making public expenditure; known as Cannons of public expenditure (originally four in number, later new cannons were added to it.) The next two chapters are devoted to :

(A) Public expenditure in India (heads of expenditure and increase over the years.)

(B) Centrel and State Expenditure in India and Expenditure Reforms Commission.

## 11.9 GLOSSARY

- **Public expenditure :** Public expenditure refers to the expenses which a government (Central/State/Local) incurs for its administration, social welfare, as well as growth and development of the country.
- **Private expenditure :** Private economic unit is guided by its own economic interests.

## 11.10 REFERENCES

1. Musgrave R.A. and Musgrave P. (2007), '*Public Finance in Theory and Practice'*, McGraw Hill.
2. Prest A.R.(1960), *'Public Finance in Theory and Practice' Weidentfeld and Nicolson.*
3. Lekhi, R.K. and Singh, J. (2012), *Public Finance*, Kalyani publishers.

## 11.11 FURTHER READINGS

1. Musgrave R.A. and Musgrave P. (2007), '*Public Finance in Theory and Practice'*, McGraw Hill.

## 11.12 MODEL QUESTIONS

1. What is Public Expenditure? Describe various cannons of Public Expenditure.
2. Differentiate between Public and Private Expenditure. Discuss various reasons for the growth of public expenditure in welfare economics.
3. Discuss the Wagner's Law of Increasing State Activities.
4. Explain Wiseman-Peacock Hypothesis of growing public expenditure in welfare economies.
5. Discuss the short-term and long-term objectives of public expenditure in under-developed countries?

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# PUBLIC EXPENDITURE IN INDIA- I

## Structure

12.0 Objectives
12.1 Introduction
12.2 Expanding Government Activity Since Independence
12.3 Growth of Public Expenditure
12.3.1 Extent
12.3.2 Causes
12.4 Public Expenditure : Classification & Components
12.5 Revenue, Capital and Total Expenditure
12.6 Developmental and Non-Developmental Expenditure.
12.7 Summary
12.8 Glossary
12.9 Reference
12.10 Further Readings
12.11 Model Questions

## 12.0 OBJECTIVES

After going through this lesson you shall be able to :

- explain the expanding role of government activity.
- discuss the extent and causes of increase in public expenditure.
- describe total expenditure and its components i.e. 'plan and non-plan' and 'revenue and capital expenditure'.
- comment upon developmental and non-developmental expenditure and its growth its India.

## 12.1 INTRODUCTION

Before India got Independence, the amount and pattern of public expenditure in this country were determined by the colonial policy of the British rulers. Changes in the expenditure policy of the government, however, became inevitable after India got Independence and the process of planning began. The nationalist government laid down its own priorities and the volume and pattern of expenditure were determined accordingly.

Before Independence, the range of the government's activities was influenced by the classical thinking. The classical economists had opposed the idea of entrusting many activities to the government. In their opinion, the activities of the government are invariable unproductive and thus a good government must attempt to minimise its expenditures. India's foreign rulers for a period followed

this approach in the framework of their colonial policy. Hence, the British rulers of India generally did not favour the idea of increasing public expenditure, at the same time they attempted to derive maximum benefit from it for the English people.

At the time of Independence, the economy of the country was in shambles due to colonial exploitation, and the partition of the country aggravated its economic difficulties. The government thus decided not to rely completely on market regulated private sector for the development of the economy. It recognised the need for development planning and assigned a strategic role to the public sector.

## 12.2 EXPANDING GOVERNMENT ACTIVITY SINCE INDEPENDENCE

The expansion in the government's activities during the post-Independence period has been both intensive and extensive. The important functions of the government are :

### (i) Defence

Right from the day India got freedom, it had to pay *increased attention to its defence,* as the partition of the country had created a belligerent nation, viz., Pakistan, in the immediate neighbourhood. India's border dispute with China since 1962 has been an additional compulsion for strengthening the defence. During the last 50 years, the USA has persistently attempted to tilt balance of power in favour of Pakistan and has supplied all kinds of military equipment to it to realise this objective. Thus India has been left with little option in this regard, as any complacency in defence matters may turn out to be disastrous.

### (ii) Maintenance of Law and Order

*Internal Security System is also being strengthened steadily.* The explanation given by the government to rationalise this policy is that increasing population and particularly the overcrowding in cities results in more crimes and thus expenditure on police is bound to increase. Many people, however, believe that the internal security system is being strengthened to supress the forces of social change. In a country, where nearly 35 per cent of the population falls below the poverty line, where exploitation of the poor is widespread and corruption has become a way of life for the elite, movements for social change and uprisings cannot be ruled out. The government is aware of their inevitability and thus expenditure on police and other instruments of law and order continues to increase.

### (iii) Education

*There has been a substantial increase in public expenditure on education during the period of planning.* Now free and compulsory education for all children between 6 and 14 years has been made a fundamental right. A number of programmes have been adopted to accomplish this objective, the most important and recent being the Sarva Shiksha Abhiyan (SSA). To enhance access to secondary education and improve its quality, Rashtriya Madhyamik Shiksha Abhiyan (RMSA) has been introduced. A number of institutions to provide higher education (including technical and management institutions) have also been set up.

### (iv) Health

*Expenditure on provision of health facilities has also increased considerably.* Particular mention of NRHM (National Rural Health Mission) needs to be made in this context. NRHM was launched in 2005 to provide accessible, affordable and accountable quality health services to rural areas with emphasis on poor persons and remote areas.

### (v) Role of Public Sector

During the planning period, *the new activities which the government undertook were broadly guided by the objective of economic growth.* Though some other objectives such as self-reliance, removal of poverty and reduction in income inequalities, creation of employment opportunities for the

involuntarily unemployed etc. have also been mentioned in the Plan documents, *the government has always concentrated mainly on realising growth targets. Hence, the public sector was assigned a significant role in the development strategy. Besides developing the infrastructure, basic industries were set up in the public sector.* The performance of the government in this field can be judged by the simple fact that whereas in 1951 there were only 5 operating enterprises in the public sector, their number increased to 246 as on March 31, 2009. The amount of investment in public sector enterprises rose from Rs. 29 crore in 1951 to as high as Rs. 5,28,951 crore as at the end of March 2009. The main industries developed in the public sector are iron and steel, petroleum, heavy engineering, machine tools, transport equipment, chemicals and drugs and mining. Had their development been left to market forces, probably private enterprise could not have accomplished what the public sector has done. These enterprises, however, have failed to generate the required re-investible surplus.

**(vi) Development of Infrastructure**

Before Independence not much attention was paid to the *development of infrastructure* in the country. Construction of railways and roads was undertaken to promote colonial interests of Britain. Development of canal irrigation was neglected for a long time and only when the famines took heavy tool of lives a moderate beginning was made in this regard. During the post-Independence period, development of infrastructure has become an integral part of the Five Year Plans. Development of transport, communications and irrigation facilities has been undertaken in a systematic manner. Power projects being the prime mover of economic development have been accorded a high priority. The planners in India had the benefit of the experience of the former Soviet Union where neglect of infrastructure in the early period proved to be a serious obstacle to growth. The Indian planners thus gave particular attention to development of social overhead capital.

**(vii) Rural Development and Agricultural Development**

Since the mid-1960s with the adoption of *new agricultural strategy,* the government has committed itself to encourage agricultural development. The success of the new agricultural strategy depended largely on increased used of fertilisers and irrigation facilities. Hence, the government has not only created larger irrigation facilities but has also provided them to the farmers at rates which do not cover even the costs. For popularising the use of fertilizers, there is a subsidy on them. No doubt these measures have induced agricultural development, but the benefit of it has gone largely to the larger and big farmers. A number of other development programmes have also been introduced which further serve the interests of the rural rich and may be prejudicial to the interests of the rural poor. Among these programmes the system of support prices to agricultural products is particularly important. It benefits only the farmers who have marketable surplus and hurts the rural poor who have to buy food at increased prices. These programmes, however, impose heavy burdens on the national exchequer.

**(viii) Employment and Poverty – Eradication Programmes**

*In an effort to alleviate poverty and tackle the problem of unemployment, the government has undertaken a number of programmes, the most important being the wage employment programmes like NREP, RLEGP, NREGS, etc., and self-employment programmes like IRDP, PMRY, etc.* The most important programme in this respect is the MGNREGS introduced in 2006-07. This programme seeks to provide at least 100 days of guaranteed wage employment in a financial year to every rural household whose adult members volunteer to do unskilled manual work. Social security measures have also been introduced during the period of planning. However, as we have stated in Chapter 34, these measures cover only a very small part of the working population as they focus only on organised labour employed in large industrial organisations. The fact is that a majority of the people (in fact, 92.0 per cent of working population) are employed in the unorganised sector and are, therefore, outside the ambit of social assistance and social insurance schemes.

### (ix) Provision of Food Security

The government has introduced three food-based safety nets to provide food security to the people: (1) public distribution system (PDS) (2) integrated child development services (ICDS), (3) mid-day meals programme (MDM). Under PDS, foodgrains are provided at highly subsidised prices to people below the poverty line.

### (x) Other Measures

The government has also undertaken several measures for export promotion, including the setting up of the State Trading Corporation and the Minerals and Metals Trading Corporation. In some other sectors also the government has taken upon itself new responsibilities.

## 12.3 GROWTH OF THE PUBLIC EXPENDITURE

### 12.3.1 Extent

Both intensive and extensive expansion in the activities of the government during the planning period has resulted in a spectacular rise in public expenditure (at current prices). In 1950-51 the total public expenditure in both revenue and capital accounts was Rs. 900 crore. It rose to Rs. 7,843 crore in 1970-71 and to Rs. 1.8 lakh crore in 1990-91. According to the revised estimates for 2009-10, the public expenditure in this year amounted to Rs. 19,09,380 crore. In 2015-16, the public expenditure was 88.4 lakh crore.

Obviously this increase in the public expenditure is quite impressive. Comparing the public expenditure with the GDP, we find that the public expenditure's ratio to the GDP has steadily risen over the years.

For estimating the rise in public expenditure, figures of absolute expenditure are less useful. In a developing economy where GDP has been steadily rising, increase in absolute amount of public expenditure is quite natural. In some developed countries of the West, the public expenditure has been rising proportionately to the increase in their GDP. Hence, the ratio of public expenditure to GDP has remained more or less stable. However, in India the ratio of public expenditure to GDP rose steadily until 1990-91. Against 9.1 per cent in 1950-51, ratio of public expenditure to GDP was 15.3 per cent in 1960-61, 17.2 per cent in 1970-71, 25.6 per cent in 1980-81 and 28.5 per cent in 1990-91. Thereafter, there was a decline in the ratio of public expenditure to GDP as the government tended to check growth in public expenditure. In 1990s, public expenditure's ratio to GDP declined only up to 1996-97. Thereafter this trend was reversed and ratio of public expenditure to GDP once again began rising. It was 29.1 per cent in 2009-10. As a result, the ratio of public expenditure to GDP declined to 24.7 per cent in 1996-97 and stood at 25 per cent in 1997-98. *Since then the trend of declining public expenditure-GDP ratio has been reversed and, as a result, in 2009-10 public expenditure-GDP ratio was once again as high as 29.1 per cent.* Now the ratio of public expenditure to GDP in India is one of the highest in developing countries and very much comparable to the ratio in the USA, Canada, the UK, France and Germany.

The USA, Canada, France, Germany and the UK are developed countries. People in these countries have now reached an income level that can easily satisfy their individual wants. Therefore, their increasing demand for services and goods which only the State can provide is not at all surprising. The situation in India is very much different. As a sizeable percentage of population is below the poverty line, many people fail to obtain even necessaries for their humane survival. They hardly derive any benefit from the public expenditure. Most of the non-development expenditure is on interest payments, defence, police, general administration and education, the benefit of which rarely percolates to the poorest sections of the society. Relatively poor people also do not benefit from subsidies. Benefits of development expenditure have been appropriated largely by the urban and the rural elite.

As the government has considerably raised indirect taxes to meet its rising expenditure, the burden of increased governmental activities has fallen on the poor and has this contributed a lot to increasing economic disparities.

### 12.3.2 Causes of the Rise in Public Expenditure in India

In this lesson, we have attempted to explain that during the period of economic planning there has been a spectacular rise in the public expenditure. Now we shall explain the reasons for this trend.

**1. Increase in GDP and Administrative Structure :** A rise in the GDP is accompanied by an increase in the population expenditure. In India, over a period of 59 years from 1950-51 to 2008-09, the GDP rose by about fifteen times and per capita income by about four and a half times. Under the circumstances, the government is not only expected to expand its traditional activities, it is also put under pressure to undertake new activities. This has actually happened in India since 1950-51. In this context, it is pertinent to mention that in a backward economy in the early period of its development, public expenditure rises at an increasing rate in response to a rise in per capita income. Once an economy is fairly developed, a stage is reached where a stable ratio between the public expenditure and the national income, will be obtained. During the period of economic planning, India has also witnessed this trend. Since 1951 the ratio of public expenditure to the GDP rose considerably in response to the rise in per capita GDP.

**2. Growth of Population :** During the six decades from 1951 to 2011 passing through the second stage of demographic transition, India has faced population explosion. In 1951 the population of India was 36 crore. It has risen to more than 120 crore in 2011. Growth in population on this scale will certainly require an increase in public expenditure. For example, expenditure on police, education, health and medical facilities rises as the demand for these services increases with population. This is true of many developmental activities also.

**3. Expansion of administrative machinery :** India had retained colonial bureaucratic system even after getting Independence. This administrative machinery is quite expensive for an underdeveloped country. Since Independence many new departments have been set up. Most of them may be necessary in view of the requirements of an independent country, but the criticism that some departments have been set up merely for accommodating important persons is not altogether baseless. Excess recruitment in government departments has become a normal feature. *According to Raja J. Chelliah, 20 to 25 per cent staff in government departments is surplus. The Expenditure Reforms Commission which looked into the working of 36 ministries/departments found that there was 42,200 person strong surplus manpower in a total sanctioned staff of 8,65,000.* Over the years due to revision of pay scales and annual increments, there has been an immense increase in the expenditure on administration. As the government relies heavily on its employees for the stability, it often gives them unnecessary concessions, which involve colossal waste of public funds.

**4. Development Projects :** An important cause of the rise in public expenditure is heavy investment in development projects. Though the government in this country has never been committed to build a socialist society, its policy towards development has always been quite unambiguous. The government wanted to transform the country's underdeveloped economy into a developed one, and thus undertook the task of developing the infrastructure and large-scale basic industries. These projects have required heavy investment over the years. In India, every new Plan has been bigger in size than the earlier ones. The investment both in financial and real terms has steadily increasing during the planning period and with it overall public expenditure has also recorded a sharp rise.

**Table 1**

**Combined Public Expenditure of Union and State/UT Governments during 1950-51 to 2009-10**

| *Year* | *Total Revenue and Capital Expenditure at Current Prices* | *Ratio of Public Expenditure to GDP* |
|---|---|---|
| (1) | (2) | (3) |
| 1950-51 | 900 | 9.1 |
| 1960-61 | 2,631 | 15.3 |
| 1970-71 | 7,843 | 17.2 |
| 1980-81 | 37,218 | 25.6 |
| 1990-91 | 1,63,520 | 28.7 |
| 1995-96 | 3,00,630 | 25.2 |
| 1996-97 | 3,40,033 | 24.7 |
| 1997-98 | 3,81,091 | 25.0 |
| 1998-99 | 4,59,002 | 26.2 |
| 1999-2000 | 5,34,511 | 27.4 |
| 2000-01 | 5,88,233 | 28.0 |
| 2001-02 | 6,44,336 | 28.3 |
| 2002-03 | 6,94,690 | 28.3 |
| 2003-04 | 7,84,664 | 28.5 |
| 2004-05 | 8,56,882 | 27.2 |
| 2005-06 | 9,59,855 | 26.0 |
| 2006-07 | 11,09,174 | 25.8 |
| 2007-08 | 13,16,246 | 26.4 |
| 2008-09 | 15,95,110 | 28.6 |
| 2010-11 | 24 Lakh Cr. | 29.1 |

1. *Revised Estimates
2. *Sources :* Reserve Bank of India. *Handbook of Statistics on the Indian Economy 2009-10,* (Mumbai, 2009), Table 115, p.204, and Government of India, *Economic Survey* 2010-11 (Delhi 2011), c.f. Lekhi, 2010.

**5. Urbanization :** Since Independence, the percentage of urban population has increased in this country. Against 17.3 per cent population living in cities in 1951, around 27.8 per cent population in-habited urban areas in 2001. The process of urbanization in any country raises various government expenditures. With more and more people migrating to cities, the police machinery has to be strengthened, transport system has to be improved and sometimes housing facilities have also to be provided. All these activities involve heavy expenditure. Until now the process of urbanization in the country has been slow and its contribution to the rise in the public expenditure is modest. But once the industrial activity picks up in this country, cities will grow rapidly and in that situation State will have to incur heavy expenditure on urban development.

**6. Subsidies :** We have already stated in this chapter that over the years subsidies have increased steeply contributing to rapid growth of public expenditure. No doubt a large class of publicly produced services, as defence, general administration and the maintenance of law and order are in the

nature of pure public goods and thus cannot be priced. However, other publicly provided services can be priced and thus their cost can be recovered. But in the consumption of some of these goods and services there may be some externalities. Therefore, if they are provided by the government at user cost prices, the privately optimal level of their consumption may turn out to be socially sub-optimal consumption. The government may, therefore, give some subsidy to ensure socially optimal level of consumption. Subsidy may also be provided in respect of consumption of a merit good, like the primary education to the poor. In India, however, there is a huge volume of subsidies involved in delivery of almost all goods and services provided by the government. Over the years, recovery rates in respect of both economic and social services have declined. As a result, the burden of subsidies has increased.

**7. Debt Finance :** Debt finance is often necessary to accelerate the pace of development. It nevertheless carries the burden of interest payments. In India, considerable reliance on debt finance under the various plans led to continuous growth in the total outstanding debt. The public debt of the Central government registered a sharp increase in the 1980s – from 41.6 per cent of GDP in 1980-81 to 55.2 per cent in 1990-91. Since then it has increased further to 61.5 per cent in 2007-08. As a result of steep rise in the public debt, there has been a dramatic increase in interest payments by the government. *The interest payments of the Central Government which were 1.8 per cent of GDP in 1980-81, rose to 4.0 per cent in 2004-05 and stood at 3.2 per cent in 2009-10.* We have written earlier also in this chapter about this factor's contribution to the growth of public expenditure.

**8. Defence :** We have already mentioned that considerable increase in defence expenditure is an important cause of overall rise in the public expenditure in India. In the Third World countries, governments have shown increasing reliance on military in the past. This tendency is largely due to internal discontent caused by widespread poverty and the rising consciousness. In most cases danger of foreign aggression is just an alibi to expand the military system. Most people think that India is no exception in this respect. The expenditure on defence in this country has risen from Rs. 3,600 crore in 1980-81 to 90,668 crore in 2009-10.

**Self Assessment Question**

Q. 1 Mention major causes affecting rise in public expenditure in India.

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## 12.4 CLASSIFICATION OF PUBLIC EXPENDITURE AND ITS COMPONENTS IN INDIA

In Budget 1987-88, the Government of India adopted a new classification under which public expenditure is classified into *Plan expenditure* and *Non-Plan expenditure*.

*Plan expenditure* includes expenditure on (a) Central Plans such as development of agriculture, rural development, irrigation and flood control, energy, industry and minerals, transport, energy, industry and minerals, transport, communication, science & technology and environment.

(b) Central Assistance for the plans of the States and Union Territories.

Non-Plan expenditure comprises of

A. Expenditure on Revenue Account.

B. Expenditure on Capital Account.

These concepts are explained as follows:

### 12.4.1 Expenditure of Revenue Account of Central Government

Generally, as major heads of revenue, expenditures are being shown in the budget of the Central Government as defence services, civil services, grants-in-aid, interest payments, tax collection and economic services. Revenue expenditures are met out of the revenue receipts of the government like tax revenues arid other revenues. This revenues expenditure is incurred for the normal running of government departments and services interest charges on debt etc. Broadly, such expenditure does not result in the creation of assets. All assets given to state governments are also considered as revenue expenditures.

A brief description of revenue expenditure has been detailed out as below:

**(a)** **Defence Expenditure :** According to Adam Smith, "*Defence is more important than opulence.*" Therefore, it is the most important item in the case of every government. For national wealth to save against external aggression and internal disorder, defence expenditure is must. It is constantly increasing as the modern warfare instruments are becoming more costlier and sophisticated. Popularly, there are three major defence services Army, Navy and Air Force. The charge on revenue account is as a result of maintenance of these forces on salarie, dearness and other allowances, pensions and retirement benefits provided to defence personnels. In 1980-81, expenditure on defence was Rs. 3867 crore which rose to Rs. 10874 crore in 1990-91 and further Rs. 18841 crore in 1995-96. Similarly, it rose to Rs. 37238 crore in 2000-2001. It was Rs. 87344 crore in 2010-11. (See Table 4, Lesson 9).

**(b)** **Civil Services :** Before independence, the aim of the government was the maintenance of law and order whereas after independence, it was sought to change from "law and order state" to "welfare state". Thus, investment in this sector has been rising continuously. It includes expenditure on Parliament administration, justice, election and on the Office of Comptroller and Auditor General. Besides, other type of expenditures are on Secretariat and attached offices of Ministries of Education arid Social Welfare, Health and Family Welfare, Information and Broadcasting, Labour and Employment and Department of Atomic Energy, Culture, Science and Technology and Space etc.

**(c)** **Grants-in-Aid to States :** State government cannot work properly without the help of central government as the expenditures of state government have gone up because of increase in salaries and allowances of government employees and functional relations with other states. The state expenditure has also continuously been on upward side to meet the plan expenditures and other welfare schemes. In 1950-51, it was Rs. 61 crore which increased to Rs. 104972 crore in 1990-91. In 1995-96, it stood at Rs. 16688 crore, Rs. 48211 crore in 2005-06 and Rs. 109092 crore in 2010-11.

**(d)** **Interest Payments :** This includes expenditure on the payment of interest on the outstanding debt. In the recent years, these payments have shown rising trend on account of expenditure incurred on the implementation of various plans. In 1980-81, Rs. 2957.00 crore were paid as interest. It was Rs. 25006 crore in 1990-91. In 1995-96, interest payment was of amounted to Rs. 58944 crore and Rs. 99314 crore in 2000-01. It rose to Rs. 248664 crore in 2010-11. (See Table 4, Lesson 11) and 4 lakhs 4 crores.

**(e)** **Collection of Taxation :** Taxes also play prominent role in the revenue of any government. A sum of Rs. 504 crore were spent to collect the taxes in 1980-91 and Rs. 1973 crore during the year 1990-91, which further rose to the level of Rs. 2430 crore in 1992-93. However, it has amounted to Rs. 2932 crore in 1993-94. Further, in 1993-94, the total expenditure on the collection of taxes was recorded to be Rs. 3391 crore. In 1995-96, expenditure on the collection of taxes amounted to Rs. 5224 crore and Rs. 6570 crore in 2000-01 and rose to Rs. 19093 crore in 2010-11.

**(f)** **Economic Services :** After independence, it has become the foremost need of the government to spend on economic services to develop the economy at a rapid rate. It includes the expenditure on Departments of Commerce, Shipping and Transport, Irrigation, Energy, Chemicals and Fertilizer, Company Affairs and Electronics, Industry and Agriculture sectors etc. It was estimated to spend on other activities of economic services to the tune of Rs. 104 crore in 1986-87 while it was Rs. 39.28 crore in 1980-81. The development expenditure in 1990-91 was Rs. 754 crore which further increased to Rs. 97867 crore in 2000-01. The total outlay for economic services was Rs. 336107 crore in 2010-11. For General, Economic & Social Services, See Table 4, Lesson 9.

**Table 2 Revenue Account Expenditure**

**(Rs. in crores)**

| Year | Amount | Total Expenditure |
|---|---|---|
| 1990-91 | 73516 | 98272 |
| 2000-01 | 277838 | 325592 |
| 2001-02 | 301468 | 362310 |
| 2002-03 | 338713 | 413248 |
| 2003-04 | 362074 | 471203 |
| 2004-05 | 384329 | 498252 |
| 2005-06 | 439376 | 505738 |
| 2006-07 | 514609 | 583387 |
| 2007-08 | 594433 | 712732 |
| 2008-09 | 658118 | 750884 |
| 2009-10 | 897232 | 1020838 |
| 2010-11 | 958724 | 1108749 |

Table 2 summarises the revenue account expenditure of the Government of India since 1990-91 which indicates that it has been continuously increasing every year like the increase in total expenditure. In 1990-91 revenue account expenditure was of Rs. 73516 crore against total expenditure of amounting Rs. 98272 crore. During 2000-01, revenue account expenditure was recorded at Rs. 277838 crore and total expenditure of Rs. 325592 crore. During 2005-06, revenue account expenditure was Rs. 439761 crore against total expenditure of ` 50578 crore. It rose to Rs. 897232 crore against total expenditure of Rs. 958724 crore in 2010-11.

### 12.4.2 Expenditure on Capital Account

Expenditure on capital account consists of expenditure for the acquisition of assets such as land, building, machinery, equipments etc. These are also like advances granted to state governments, companies and other such organisations which tend for development activities. The expenditure on capital account is financed out of the capital receipts like market loans and borrowing by the government from domestic as well as foreign resources. Therefore, capital account, expenditure consists of all those expenditures used for the acquisition of assets like land, buildings, machinery equipment as investment in share etc. and loans and advances of State Governments by the Central Government. It also includes Government companies, corporations and other such institutions for their development activities.

Here, we must remember that revenue and capital account expenditure, both collectively are known as Economic Classification of the budget. Revenue and capital expenditure can be further classified in the economic functional classification of the budget. It means a more detailed break-up of revenue and capital expenditure. In a sense, functional classification of public expenditure aggregates budget data in a particular period to show the share of public expenditure devoted to each sector. This data is more significant for policy formulation, review and implementation of various development schemes.

Capital account expenditure as provided in the budget of the Government of India, has been illustrated as under:

**1. General Services :** This head refers the expenditure on currency, coinage and mint. It also includes expenditures of fiscal services like India's contribution to international Monetary Fund and other international financial institutions. Furthermore, it consists capital expenditures on public works and expenditure on non-residential buildings.

**2. Defence Services :** This head consists of Central Government expenditure on capital as on army, navy and air force. It includes capital expenditures on the construction of non-residential buildings, ordinance factories, machine tools and other equipments etc.

**3. Social Services :** Social services are helpful to raise the efficiency and productivity of human resources. They are also useful from the point of raising the standard of living of common masses. Therefore, they include the expenditure on the services like education, health, art, culture, family planning, sanitation, water supply, housing, urban development, social security, welfare activities and scientific development etc.

**4. Economic Services :** Capital expenditure on economic services are of the kind of foreign trade and other allied services like irrigation, animal husbandry, dairy, fishery development, industrial and mineral development, atomic energy, mining and metallurgical industries, water and power development, transport and communication etc.

**5. Loans and Advances to States and Union Territories :** Generally, State Governments and Union Territories face acute shortages of fund to meet the requirement of development activities in the region. Therefore, Central Government provides them loans and assistance to undertake such development activities.

Table 3 provides capital expenditure of the government since 1990-91. The statistical data of this table shows that it has also been continuously increasing at a very high speed. It must be remembered here that revenue expenditure does not result in creation of assets whereas capital expenditure results in creation of assets.

**Table 3. Capital Account Expenditure**

**(Rs. in crore)**

| Year | Amount | Total Expenditure |
|---|---|---|
| 1990-91 | 24756 | 98272 |
| 2000-01 | 47754 | 325592 |
| 2001-02 | 60842 | 362310 |
| 2002-03 | 74535 | 413248 |
| 2003-04 | 109129 | 471203 |
| 2004-05 | 113923 | 498252 |
| 2005-06 | 66362 | 506123 |
| 2006-07 | 68778 | 583387 |
| 2007-08 | 118238 | 712732 |
| 2008-09 | 92766 | 750884 |
| 2009-10 | 123606 | 1026838 |
| 2010-11 | 150025 | 1108749 |

***Source:*** Lekhi, 2009

In 1990-91, capital account expenditure was registered at Rs. 24756 crore against total expenditure of Rs. 98272 crore. During 2000-01, total expenditure rose to Rs. 325592 crore against capital expenditure of Rs. 47754 crore. Again it was expected to be Rs. 123606 crore and Rs. 150025 crore respectivdiy in 2010-11.

## 12.5 REVENUE, CAPITAL AND TOTAL EXPENDITURE: COMBINED PICTURE

Table 4 exhibits the over-all view of revenue, capital and total expenditure since 1990-91. It seen from the table that revenue expenditure has continuously been increasing as of total expenditure. For instance, in 1990-91, revenue expenditure was put up at Rs. 73516 crore while total expenditure was of Rs. 98272 crore. In this year, capital expenditure was Rs. 24756 crore. In 2000-01 total expenditure stood at Rs. 325592 crore against Rs. 277838 crore and Rs. 47754 crore as reserve and capital expenditure respectively. However, total expenditure rosé to Rs. 506123 crore while revenue expenditure Rs. 439761 crore and capital expenditure Rs. 66392 crore in 2005-06. Further, it was expected to be Rs. 958724 crore, Rs. 150025 crore respectively against total expenditure of Rs. 1108749 crore in 2010-11.

**Table 4. Over-all view of Revenue Capital and Total Expenditure**

**(Rs. in crore)**

| Year | Revenue | Capital | Total Expenditure |
|---|---|---|---|
| 1990-91 | 73516 | 24756 | 98272 |
| 2000-01 | 277838 | 47754 | 325592 |
| 2001-02 | 301468 | 60842 | 362310 |

| 2002-03 | 388713 | 74535 | 413248 |
|---|---|---|---|
| 2003-04 | 362070 | 109129 | 471213 |
| 2004-05 | 384329 | 113923 | 498252 |
| 2005-06 | 439761 | 66362 | 506123 |
| 2006-07 | 514609 | 68778 | 583387 |
| 2007-08 | 594433 | 118238 | 712732 |
| 2008-09 | 658118 | 92766 | 750884 |
| 2009-10 | 897232 | 123606 | 1020838 |
| 2010-11 | 958724 | 150025 | 1108749 |

**Source:** Lekhi, 2009.

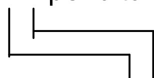
### 12.5.1 Plan and Non-Plan Expenditure

First of all it needs to be clarified that the Plan and Non-Plan expenditure do not necessarily refer to Developmental and Non-Developmental expenditure respectively, though they do contain the elements of development as well as non-development expenditure. As plan projects become operative, the expenditure on its maintenance and operations are transferred to non-plan budget. That is why Non-Plan expenditure, due to the abovesaid reason, continue to increase. Thus, every new plan project would transfer some liability towards non plan expenditure ultimately. Moreover, the rate of increase of non-plan expenditure is higher than that of plan expenditure. Table 1 gives details of Plan and Non-Plan expenditure in India for three decades1980-2010.

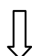
Plan Project (Plan Expenditure)

Till the Completion of the Project

(Plan Expenditure)



When Operational



Expenditure on Operation & Maintenance = Non-Plan Expenditure

It is observed that currently approximately 80 p.c. of the *plan expenditure* is used for financing the central plan while balance is given as central assistance for the States and the UTs. In *non-plan expenditure, capital expenditure* comprises a little more than 1 percent (i.e. 1.2 p.c.) and 99 p.c. approximately, hence, of the non-plan expenditure is incurred on the *revenue account*. This revenue expenditure includes (1) debt servicing charges, (2) defence expenditure, (3) subsidies, (4) grants and (5) other expenditure. The first three components are observed to account for more than of 71 p.c. of the expenditure in the year 2009-10.

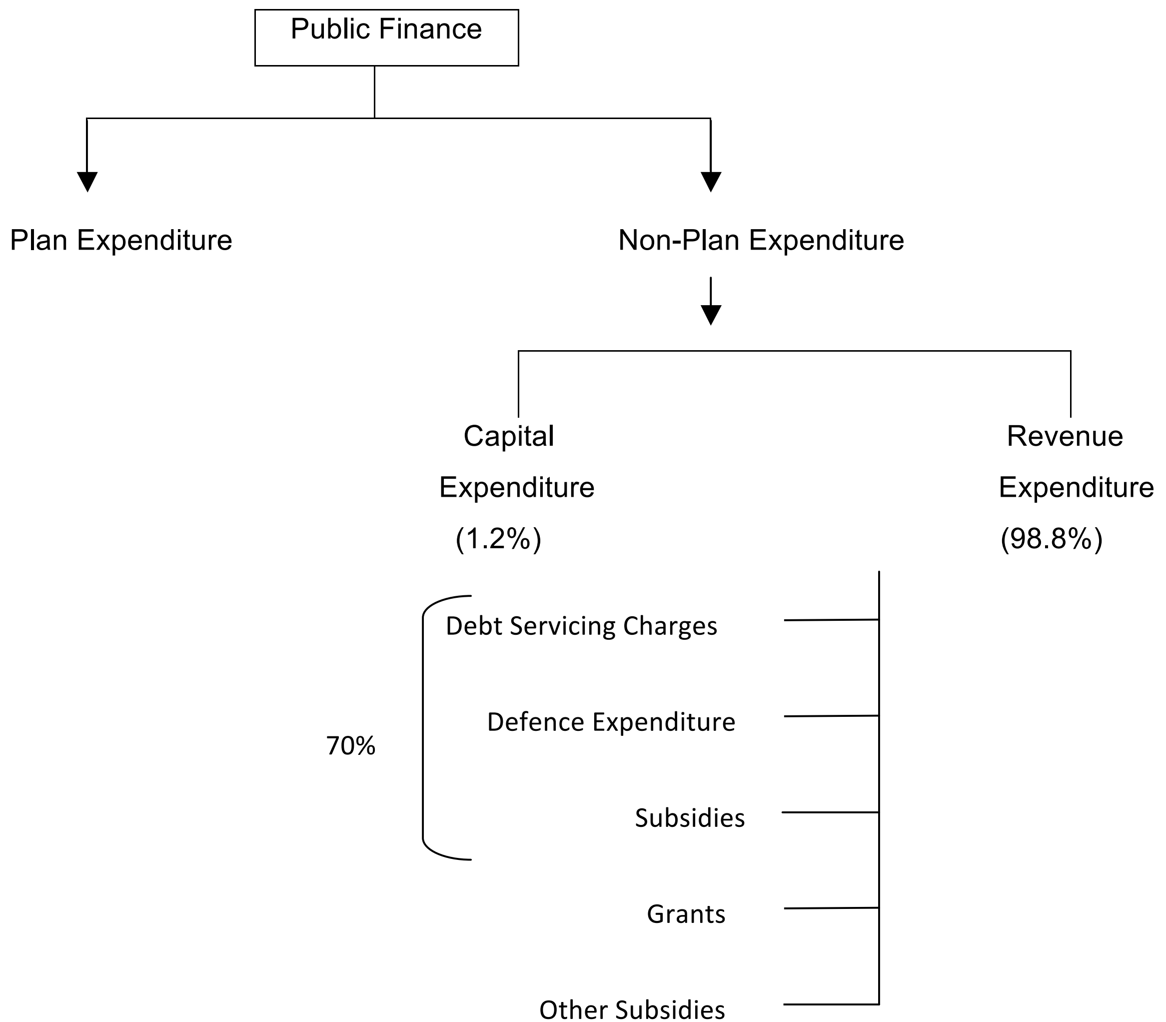



Table 5 presents figures of Plan and Non-plan expenditure in India for three decades 1979-80 to 2009-10.

The Plan Expenditure has almost tabled from Rs. 7189 crores in 1979-80 to Rs. 2,13,410 crores in 2009-10. Parallily the Non-plan expenditure has also increased from Rs. 10,598 crores to Rs. 4,13,410 crores (40 times). We should keep in mind that the figures are not at constant prices, obvcously the non-plan expenditure has also increased faster.

**Self Assessment Question**

Q. 2 Differentiate between Plan and Non-Plan expenditure.

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**Table 5 : GOI Expendture – Plan and Non Plan (In Crore)**

| | 1979-80 | 85-86 | 89-90 | 90-92 | 96-97 | 99-2000 | 02-03 | 03-04 | 06-07 | 07-08 | 08-09 | 09-10 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| A. Plan expenditure | 7189 | 12360 | 24146 | 59326 | 227608 | 385940 | 111470 | 122280 | 137387 | 143497 | 172456 | 213410 |
| 1. Central Plan | 4196 | 8110 | 15826 | 34592 | 125879 | 219099 | 67126 | 71842 | 82529 | 110385 | 115234 | 125345 |
| 2.Assistance For State UT Plans | 2993 | 4250 | 8819 | 24734 | 101739 | 166840 | 84344 | 50438 | 54858 | 33112 | 57222 | 88065 |
| B Non Plan | 10598 | 18698 | 47026 | 157386 | 576884 | 1111408 | 301778 | 349088 | 368404 | 370847 | 392626 | 413410 |
| 1. Interest Payment | 2210 | 4101 | 12009 | 48096 | 221399 | 440542 | 117804 | 124088 | 125905 | 133945 | 145910 | 15367 |
| 2. Defence Expenditure | 3164 | 5169 | 11638 | 31773 | 119033 | 226174 | 55662 | 60066 | 77000 | 83000 | 85162 | 87412 |
| 3. Subsidies | 1543 | 2604 | 6887 | 24411 | 62448 | 124668 | 43553 | 44256 | 46514 | 47432 | 49900 | 98413 |
| 4. Grants to States & UT's | 624 | 790 | 1924 | 7903 | 19581 | 45625 | 13305 | 13721 | 14828 | 33953 | 40110 | 45213 |
| 5. Othergrants | 58 | 76 | 116 | 286 | 927 | 1853 | 605 | 688 | 936 | 1094 | 1516 | 1810 |
| 6. Other Non Plan Expandture | 2215 | 3550 | 9756 | 23002 | 96124 | 205186 | 49786 | 55977 | 63000 | 63160 | 70210 | 79790 |
| 7. Other Non-Plan capital Expenditure | 107 | 427 | 662 | 1729 | 5481 | 8383 | 13328 | 46745 | 36019 | 4460 | 5153 | 7017 |
| 8. Loans and Advances to states | 132 | 1109 | 5751 | 13138 | 41889 | 41886 | 2481 | 178 | 715 | 100 | 124 | 156 |
| 9. Other Loans | 545 | 708 | 1207 | 7050 | 100021 | 9509 | 3385 | 1587 | 1560 | 1219 | 2241 | 5319 |

**Source :** GOI Budgets and Expendture Budgets

Note : Pl. update Data

## 12.6 DEVELOPMENT AND NON-DEVELOPMENTAL EXPENDITURES

Obviously, Public expenditure is said to be developmental and non-developmental in nature. Therefore, they may be classified as:

(a) Developmental Expenditure on Revenue Account.

(b) Developmental Expenditure on Capital Account.

(c) Non-Developmental Expenditure on Revenue Account.

(d) Non-Developmental Expenditure on Capital Account.

**(a) Developmental Expenditure on Revenue Account :** It is the expenditure that directly contributes to the developments of the economy. It refers to expenditure made to create economic and social overheads like transport, roads, communication, education, art, culture, medical, family welfare, public health, labour, employment, scientific services and other community services etc. Development expenditure also consists expenditure on economic services such as agriculture and allied services, industries, minerals, foreign trade and export promotion, water and power development, transport and communication etc.

**(b) Developmental Expenditure on Capital Account :** The main items under developmental expenditure are on social community services, economic services, loans to state and union territories for developmental projects and public enterprises.

**(c) Non-Developmental Expenditure on Revenue Account :** It includes expenditure on audit collection of taxes and duties, currency, coinage and mint. Besides, payments on administrative services like police, external affairs and other administrative services, pensions, other retirement benefits, grants to states and union territories are also accounted in non development expenditure on revenue account.

**(d) Non-Developmental Expenditure on Capital Account :** It consists of the expenditure on defence, state trading schemes, currency, mint, security and printing press etc.

Table 11.6 shows the developmental and non-developmental expenditure of the Central, State Governments and Union Territories since 1980-81. Total expenditure on developmental and non-developmental expenditure was Rs. 36845 crore in 1980-81 which increased to Rs. 176548 crore in 1990-91 and further Rs. 340313 crore in 1995-96. During 2000-01, total expenditure was recorded of amounting Rs. 615658 crore in 2000-01 and Rs. 2066512 crore in 2009-10. However, individually developmental expenditure was Rs. 22426 crore in 1980-81 and Rs. 105922 crore in 1990-91 and further Rs. 189050 in 1995-96. It was Rs. 317464 crore in 2000-01. It is expected to be Rs. 1183036 crore in 2009-10 against Rs. 342234 crore in 2001-02. Similarly non-developmental expenditure in 1990-91 was recorded of Rs. 70626 crore against Rs. 12419 crore in 1980-81. Moreover, non-developmental expenditure increased to Rs. 298194 crore in 2000-01 and further rose to be Rs. 883476 crore in 2009-10.

**Table 6 Developmental and Non-Developmental Expenditure of the Central State Governments and Union Territories**

**(Rs. in crore)**

| Year | Developmental Expenditure | Non-Developmental Expenditure | Total Expenditure |
|---|---|---|---|
| 1980-81 | 24426 | 12419 | 36845 |

| | | | |
|---|---|---|---|
| 1990-91 | 105922 | 70626 | 176548 |
| 2000-01 | 317464 | 298194 | 615658 |
| 2001-02 | 342234 | 338675 | 680909 |
| 2002-03 | 354636 | 370506 | 725142 |
| 2003-04 | 400013 | 403261 | 803274 |
| 2004-05 | 438454 | 457642 | 896096 |
| 2005-06 | 552009 | 492500 | 1044509 |
| 2006-07 | 671714 | 543615 | 1215329 |
| 2007-08 | 881671 | 608531 | 1490202 |
| 2008-09 | 990690 | 703289 | 1693979 |
| 2009-10 | 1183036 | 883476 | 2066512 |

**Source:** Economic Survey, 2010-11.
Note : Pl. update Data

### 12.6.1 CAUSE OF INCREASE IN GOVERNMENT EXPENDITURE (OR CONSTITUENTS)

In India, the government expenditure is broadly classified under two heads, viz., development expenditure and non-development expenditure.

### A. Development Expenditure

**1. Expansion in Development Activities :** The main reason for spectacular rise in the public expenditure during the planning period has been expansion in developmental activities over the years. The ratio of the developmental expenditure to the total expenditure was 36.2 per cent in 1950-51. For a period of three decades, i.e. upto 1980-81, it increased considerably (in 1980-81, the ratio of development expenditure to total expenditure was as high as 64.6 per cent). However, since 1980-81 development expenditure, as a proportion of total public expenditure declined. It was 59.8 per cent in 1990-91. There was a significant decline in it during the liberalization phase. In 2000-01, the ratio of development expenditure to total public expenditure was only 51.6 per cent. This fell further to 50.0 per cent in 2006-07. *The ratio of development expenditure to public expenditure rose to 59.5 per cent in 2007-08 and stood at 58.0 per cent in 2008-09.*

It would be of interest to note that the period of 1990s (beginning right from the early 1990s) was marked by a significant increase in public expenditure. However, the ratio of development expenditure to total expenditure is now lower. A high proportion of development expenditure, in itself, cannot be considered a good thing. For deciding how far an increase in development expenditure is justifiable, one must examine the heads under which expenditure has been incurred. Other related aspects which are also to be taken into consideration are the priorities laid down for development expenditure, allocation of financial resources to various sectors, observance of various canons of public expenditure, and the amount of benefit accruing to the society from the development expenditure.

Economic planning in India is different from that in the socialist countries in approach as well as in coverage. We have opted for a mixed economy, implying the co-existence of public and private sectors. The initiative of the State in such a social system is restricted to sectors which fail to develop either due to inabilities or the indifference of the private sector. *Thus the State accorded a very high priority in India to the development of the infrastructure under the Plans*. Development of roads and railways, construction of canals, production of energy, etc. create conducive environment for rapid

economic development. Multi dimensional development of the social overhead capital by the State gives incentive to the private sector to raise the output. This strategy has worked well in respect of consumer goods industries. The State, however, could not rely for the development of basic industries on the response of the private sector to growth of the social overhead capital. *Following Mahalanobis strategy of development, the State accorded a high priority to large scale basic industries.* The development of iron and steel, heavy engineering, machine tools and chemical industries was undertaken in the public sector. Massive allocation of funds to these industries resulted in their rapid development which considerably strengthened the country's industrial structure.

**2. Increasing Expenditure on Subsidies :** In the revenue account, development expenditure has risen rapidly due to accelerated increase in the amount of subsidies. The Central government expenditure on major subsidies was as large as 2.2 per cent of the GDP in 1989-90 as against 1.4 per cent in 1980-81. However, as part of fiscal correction efforts, public expenditure on subsidies was reduced. In 2009-10, it was 1.9 per cent of the GDP. The absolute amount of subsidies by the Central government in 2009-10 was Rs. 1,23,396 crore. This is estimated to have increased further to Rs. 1,64,153 crore in 2010-11. The major subsidies presently are on food, fertilisers and petroleum. To begin with when these subsidies were introduced in this country there was some justification for them. Now those who are benefiting from these subsidies have developed vested interests in them. The government is now attempting to reduce the fertiliser subsidy. The subsidy on food aims at ensuring the supply of foodgrains to the weaker sections of the society at reasonable prices. In practice, however, the benefit of food subsidy has not gone to the poorest of the poor who live in rural areas and are usually not covered under the public distribution system. The benefit of fertiliser subsidy has been largely appropriated by the fertiliser industry and big and large farmers. The subsidies on export were in essence a device to reward the producer who inspite of the fact that he had remained inefficient wished to enter the export market. In addition to these subsidies, there are subsidies on services provided by railways, roadways and the credit provided by the State owned financial institutions. These are known subsidies and their magnitudes are indicated in the budget. But hidden subsidies (which are not small in magnitude) do not get correctly reflected in the budget. Examples of hidden subsidies are cheap higher education, more or less free medical services in government hospitals, power supply to farmers and almost free irrigation facilities provided by the State to agriculturists. According to the estimates of Sudipto Mundle and M. Govind Rao, between 1977-78 and 1987-88 the total volume of government subsidies (including implicit subsidies) rose from about 8.2 per cent of the GDP to over 15 per cent. The White Paper on Subsidies circulated among the Parliamentarians had put the total subsidy handed out by the Central and State governments at 15 per cent of the GDP. In absolute terms this would translate to about Rs. 1,85,000 crore.

Based on the study of the National Institute of Public Finance and Policy (NIPPP) the government placed a report on Central government subsidies in Parliament on December 23, 2004. According to the report, *subsidies amounted to* Rs. *1,04,113 crore in 2002-03 and* Rs. *1,15,825 crore in 2003-04. The Central Government subsidies thus constituted 4.25 per cent of GDP in 2002-03 and 4.18 per cent of GDP in 2003-04.* Subsidies on social services constituted 12.8 per cent and 14.1 per cent of total subsidies in 2002-03 and 2003-04 respectively with the rest accounted for by economic services.

**3. Relative Importance of Social Declines:** During the last five and a half decades, relative importance of social services such as education, and medical facilities has declined. In fact, throughout the 1990s social sector expenditure as a proportion of GDP was what it was in the late l980s. In Western Countries, expenditure on education is treated as an investment in man, and is thus considered productive of human capital. Some empirical studies in the West have also led to the conclusion that both general and technical education raise the productivity of labour. The East Asian

economies too recognised the importance of universal education in facilitating long-term economic development within an egalitarian framework.

Compared to the West, there is great scarcity of physical capital in India, and until its supply becomes abundant, it is rather difficult to raise productivity merely by giving general or specialised technical education to the labour. In view of this fact, it is quite rational that the development of infrastructure and basic industries has been given priority over the social services. The decline in relative importance of social services, however, does not suggest that absolute expenditure under this head has not increased during the planning period. A.K. Sen is right in stating that the government had been primarily guided by the interests of the elite groups, and thus it is not at all surprising that the primary education has been somewhat neglected.

**4. Economic Growth does not Correspond to Increasing Development Expenditure :** It is rather strange that in spite of continuously increasing development expenditure, economic growth has not risen to levels already achieved in many other less developed countries. Repeated occurrence of economic stagnation raises serious doubts about the rationality in the allocation of resources. *The functional classification of expenditure shows that the real per capita expenditure on agriculture (which includes irrigation) and transport services has declined over the past two decades. This in fact is the result of squeeze on capital expenditure.* Over the years there has been dramatic increase in the sphere of interest payments, subsidies and compensation to government employees. This has seriously affected the economy's growth performance.

In addition to the problems created by the sequeeze on capital expenditure there are some other areas of concern. In the *first* place, it is often rightly alleged that the government has generally violated the canon of economy. This criticism has some definite basis. We all know that the public funds are recklessly squandered under Plans and possibly this is the reason why in spite of targeted money spending being realised, physical targets are seldom achieved. Expenditure on the community development projects and small irrigation has generally turned out to be wasteful. *Secondly*, corruption has got institutionalised in the Indian society and the public sector has failed to escape from it. Therefore, in spite of rising money spending on the government projects, the rate of growth has not picked up correspondingly. *Finally*, large unutilised capacity has existed in public enterprises for over two decades. This cannot be explained in terms of deficiency in effective demand. Unfortunately an inter-sectoral imbalance has developed in the economy over the years. Therefore, whereas in some industries unutilised capacity exists, some other industries find it difficult to meet existing demand with their present capacity. This is an outcome of inconsistencies in the Indian planning.

## B. Non-Development Expenditure

Although during the first three decades of the planning period, the relative importance of non-development expenditure had declined, the absolute amount of expenditure under non-development heads had increased. Since 1980-81 not only non-development expenditure has increased in absolute terms but the ratio of non-development expenditure to total public expenditure has also risen. Non-development expenditure is considered desirable from administrative point of view and has a tendency to increase with the growth in population and per capita income. However, sharp increase in non-developmental expenditure in a developing country like India where there is a scarcity of resources, is not justified.

**1. Defence :** The expenditure on defence in 1980-81 was Rs. 3,600 crore. Over the years it rose considerably. It was Rs. 10,874 crore in 1990-91, Rs. 37,238 crore in 2000-01 and Rs. 90,668 crore in 2009-10. Whether this rise in expenditure on defence is justified, is a moot point. Some people think that defence technology has undergone a rapid change over the years making most military

equipment obsolete. A country, under the circumstances, can postpone modernization in defence at a great security risk, particularly when it is surrounded by belligerent nations.

**2. Interest payments :** Interest on public debt is generally considered to be unproductive. During the planning period, expenditure under this head has increased considerably. *In 2009-10 interest payments of the Central government alone were as high as* Rs. *2,25,511 crore which was 2 per cent of the GDP*. This is definitely a heavy burden on the exchequce. This was inevitable as the government had relied greatly growing for raising the resources under various plans. Over time as the amount of public debt increased, the interest liability of the government also rose. The expenditure under this head can be reduced through quick retirement of a part of the public debt. Mundle and Govind Rao assert, "This could be financed by the proceeds from the sale of public sector equity, instead of using such proceeds to finance the current expenditure of the government". They also recommend reduction of interest charges (net of dividends) payable on government debt to the Reserve Bank of India. "This monetised debt", they argue, "has arisen out of seigniorage and should not be treated at par with other public debt. For future the government will have either to cut down its development expenditure by keeping its role confined to the development of infrastructure and human development or by drastically cutting down fresh recruitment of government staff along with abolition of large number of posts which have proliferated in recent years. The Expenditure Reforms Commission which looked into the working of 36 ministries/departments has concluded that nearly 5 per cent of the manpower is absolutely redundant and its exit will provide a little elbow room to the government for carrying out some additional development activities outside the areas of infrastructural and human development. In any case, the government must not allow debt growth to become explosive. If that happens, the economy will be in jeopardy.

**3. Tax Collection Charges :** Expenditure on tax collection has also increased steadily. One can have an idea of the rate at which it has been increasing over the years from the fact that the *expenditure of the Central and State governments under this head rose from* Rs. *1,973 crore in 1990-91 to* Rs. *6,570 crore in 2000-01 and further to* Rs. *16,217 crore in 2009-10*. The oft repeated reason for such an increase in expenditure on tax collection is that salary bills of the employees in tax department cdnstitute the major item under the head and they continue to increase with passage of time. But there is another reason which is not so often mentioned. In India, the administration in the various tax departments is top heavy. The complex nature of taxation structure in the country has resulted in large recruitment of the staff. In some cases this has resulted in excessive employment and possibly Simon Kuznets is right in stating that in countries like India disguised unemployment now exists in various tax departments.

**4. Police :** Expenditure on the police has risen considerably over the years. It is presently around 3.3 per cent of Central government's expenditure. By any standard it is a fairly large allocation, and it has continued to increase over the years but still the crime situation has deteriorated. It is widely believed that the police in India is both corrupt and inefficient. It is a sad commentary on the working of the Police Department in the country. What is today required is not that the expenditure under this head is increased, but attempts have to be made to raise the level of efficiency in the Police Department.

## 12.7 SUMMARY

The public expenditure continues to increase overtime as explained in theories. As for as Indian pictures is concerned, the revenue and capital expenditure both have increased in case of development expenditure and non-development expenditure.

## 12.8 GLOSSARY

- **Plan Expenditure:** Plan expenditure is used for financing the central plan and giving assistance for States and UTs.
- **Non-Plan Expenditure :** As plan project become operative, the expenditure on its maintenance and operations are transferred to non-plan budget. Thus every new plan project transfers some liability towards non-plan expenditure ultimatily. It is farther divided into Revenue and Capital expenditures.
- **Revenue Expenditure :** Revenue expenditure is financed out of revenue receipts both tax-revenue and non-tax revenue.

## 12.9 REFERENCE


- Lekhi, R.K. and Singh, Joginder (2015), *Public Finance.* Kalyani Publishers.


## 12.10 FURTHER READINGS


- Datt and Mahajan (2017), *Indian Economy*, S. Chand Publications Pvt. Ltd.
- Misra and Puri (2016) Indian Economy. Himalaya Publishing House.
- Government of India, *Economic Survery* 2017-2018, Ministry of Finance and Latest issue
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## 12.11 MODEL QUESTIONS :

1. Comment upon the growth of public expenditure in India. Which factors have contributed towards the present situation?

**APPENDIX**

| Central Government Spending (in Rs. Crores) | | | | |
|---|---|---|---|---|
| | **2013-2014 (Actual)** | **2014-2015 (Actual)** | **2015-2016 (RE)** | **2016-2017 (BE)** |
| Plan Expenditutre | 4,53,327 | 4,62,646 | 4,77,197 | 5,50,010 |
| Non-Plan Expenditure | 11,06,120 | 12,01,029 | 13,08,194 | 14,28,050 |
| Total Expenditure | 15,59,447 | 16,63,673 | 17,85,391 | 19,78,060 |

**Source: Union Budget Documents** [RE: Revised Estimate, BE: Budget Estimate]

Govt is going to do away with plan, Non-Plan Spending classification from 2017-18. The central government expenditure will be classified as capital and revenue, spending only.

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**Lesson-13**

# PUBLIC EXPENDITURE IN INDIA : II

**Structure**

13.0 Objectives

13.1 Introduction

**Section-I**

13.2 Central Govt. Budgets

13.3 Revenues of Central Govt.

13.4 Expenditure of Central Govt.

13.5 New Classification : Plan and Non-Plan

13.6 Trands in Central Expenditure

**Section-II**

13.7 Budgets of State Government

13.8 Public Expenditure Management

13.9 Expenditure Reforms Commission

13.10 Summary

13.11 Reference

13.12 Further Readings

13.13 Model Questions

## 13.0 OBJECTIVES

After going through this lesson, you shall be able to :

- comment upon budgets and expenditure of central and state governments of India.
- discuss public expenditure management.
- explain expenditure reforms commissions recommendations.

## 13.1 INTRODUCTION

In this lesson we shall discuss Public Expenditure of the Central and State Governments of India which (public expenditure) has been explained alongwith their Receipts, together known as Budget (Central & State); and trends related to expenditure and revenue. The lesson has been divided into following subheads:

## 13.2 CENTRAL GOVERNMENT BUDGETS (SINCE 1950-51)

The Budget of the Government of India for any year, gives a complete picture of the estimated receipts and expenditures of the Government for that year on the basis of the budget figures of the two previous years. Every budget, for instance, gives three sets of figures: (a) actual figures for preceding year, (b) budget and revised figures for the current year, and (c) budget estimates for the following year. For instance, the budget estimate for the year 2008-09 contains: (a) "actuals" - or accounts for the year 2006-07 (b) budget and revised figures for the year 2007-08 and (c) budget estimates for 2008-09.

The budget in India is divided into two parts, viz, revenue budget or revenue account and capital budget or capital account.

### 13.2.1 Current or Revenue Budget

The revenue budget of the Central Government deals with receipts from taxation and from non-tax sources and expenditure met out of these sources.

**Tax revenue** comes broadly from three sources:

(a) Taxes on income and expenditure

(b) Taxes on property and capital (or property) transactions; and

(c) Taxes on commodities and services.

**Non-tax revenue** consist of :

(i) currency, coinage and mint.

(ii) interest receipts and dividends and

(iii) other non-tax revenue.

*Current expenditure or revenue expenditure* is met out of current revenues. Revenue expenditure is on : (a) such general services as general administration including police, judiciary, defence, collection of taxes; (b) social and community services, such as education, medical and public health, labour and employment; and (c) economic services like agriculture, industries, transportation, trade, etc.

### 13.2.2 Capital Budget

Capital budget of the Government of India, also known as the capital account consists of capital receipts and capital expenditure. ***The capital receipts*** of the Central Government are composed of:

- net recoveries of loans and advances made previously to State Governments. Union Territories and Public Sector undertakings.
- net market borrowings (i.e. gross borrowings from the market less repayments of public debt);
- net small savings collections (gross collections less share of the States); and
- other capital receipts such as provident funds, special deposits, etc.

***Capital expenditure*** of the Union Government consists of expenditure on capital items, mainly in the form of loans to States and Union territories for financing plan projects and other capital expenditure on economic development, on social and community development and capital expenditure on defence.

### 13.2.3 Trends in Central Govt. Budgets

In table 1, we have summarized the Central Government budgets since 1950-51 for selected years to show the growth of receipts and disbursements of the Government of India during the last 60 years. From Table 1, the following trends may be noted:

**Table 1 : Budgets of the Central Government since 1950-51**

(Rs. crores)

| | **1950-51** *Actuals* | **1980-81** *Actuals* | **2001-02** *Actuals* | **2010-11** *Budget* |
|---|---|---|---|---|
| **Revenue Account** | | | | |
| Receipts | 406 | 12,830 | 2,01,450 | 6,82,212 |
| Expenditure | 347 | 14,540 | 3,01,610 | 9,58.724 |
| Revenue surplus (+) | | | | |
| Revenue deficit (-) | +59 | -1,710 | -1,00,160 | -2,76.512 |
| **Capital Account** | | | | |
| Receipts | 120 | 8,770 | 1,61,000 | 4,26.537 |
| Disbursements | 182 | 9,630 | 60,840 | 1,50,025 |
| Deficit/Surplus | -62 | -860 | +1,00,160 | -2,76.512 |
| **Over-all budgetary deficit** | **-3** | **-2570** | **Nil** | **Nil** |

**Source:** Government of India, Budget at a Glance, 2009-10 and earlier issues c.f. Dutt and Sundaram, 2010.

**Note:** Pl. update Data

***(i) Huge Increase in Revenue Expenditure :-*** Expenditure on the revenue account has been rising very fast. For instance, revenue expenditure was Rs. 347 crores in 1950-51; which rose to Rs. 14,540 crores in 1980-81; and Rs. 9,58,724 crores in 2010-11 (Budget).

In the first 30 years (1951-81) revenue or current expenditure of the Central Government had risen by more than 40 times.

In the next 29 years (1981-2010) revenue expenditure of the Central Government had risen by 62 times. The current expenditure of the Central Government is rising fast.

This enormous increase in public expenditure of the Central Government was due to expansion of government machinery, new responsibilities, new departments, increase in Government of staff, increase in defence expenditure and continuous rise in the salaries and dearness allowances of Government servants because of the rise in prices and the consequent rise in the cost of living, and huge increase in interest payments.

***(ii) Huge Increase in Revenue Receipts :*** To meet its current expenditure, the Central Government raises certain taxes and an other receipts. Revenue receipts had increased from Rs. 406 crores in 1950-51 to Rs. 12,830 crores in 1980-81 and Rs. 6,82,212 crores in 2010-11 (Budget).

During the first 3 decades (1950-81) revenue receipts rose by 30 times. During the next 29 years (1981-2010) revenue receipts rose by nearly 48 times.

This huge increase in revenue receipts reflects the imposition of new taxes, broadening the tax coverage, better tax administration and rise in prices and incomes due to general inflationary pressure and consequent increase in tax revenues.

One thing is clean from the above two points. Both revenue expenditure and revenue receipts were rising fast and regularly over the years. However, rise in revenue expenditure exceeded the rise in revenue receipts — thus, resulting in revenue deficit.

***(iii) Mounting Deficit in Revenue Account :*** Till the middle of the 1970's, current receipts exceeded current expenditure *resulting in surplus in the current account*; this was known as revenue surplus. For instance, the revenue surplus was Rs. 50 crores in 1950-51; it rose to Rs. 160 crores in 1970-71. The Indian Government used this revenue surplus to finance economic development.

Since the middle of 1970's, however, the revenue expenditure has been rising much faster than current revenue, resulting in deficit in the revenue account. For instance, in 1980-81, the revenue deficit was Rs. 1,710 crores and in 2001-02, it touched Rs. 1,00,160 crores. The Government of India took a series of steps, specially to raise tax revenue and thus reduce revenue deficit and was successful initially. But revenue deficit again jumped to 2,76,512 crores in 2010-11 (budget).

Deficit in the revenue account implies that the Government is living beyond its means and that it is forced to borrow even to meet its current expenditure. This is indeed a sad state of affairs in India. As mentioned above, the Government is taking steps to reduce revenue deficit.

## 13.3 REVENUES OF THE CENTRAL GOVERNMENT

As mentioned above, the Central Government has

(a) Revenue budget that is to say the estimates of receipts and disbursements on Revenue Account and

(b) A Capital budget which relates to receipts and disbursements on Capital Account.

In this section, we shall describe in great detail the revenue budget. The estimates of receipts on revenue account have been grouped under two broad heading viz, tax revenue and non-tax revenue.

**Revenue Receipts**

Table 3 reveals that the total current revenue of the Central Government consists of Tax revenue, and non-tax revenue. This has been rising quite fast, partly on account of more taxes and higher rates of taxes, and partly due to inflation. The total revenue receipts of the Central Government was a little more than Rs. 400 crores in 1950-51 but it rose to Rs. 12,830 crores in 1980-81 and in the 2010-2011 budget, it would be 6,82,212 crores. Between 1981 and 2010, the total revenue receipts had increased by 53 times.

Hence, total revenue receipts come from two sources : tax revenue and non-tax revenue.

**Table 3 : Revenue of Central Government in the Revenue Account I**

**(*Rs. crores*)**

| | **1950-51** ***Actuals*** | **1980-81** ***Actuals*** | **2001-02** ***Actuals*** | **2010-11** ***Budget*** |
|---|---|---|---|---|
| Tax Revenue (net) | 357<br>(88) | 9,390<br>(73) | 1,33,660<br>(66) | 5,34,094<br>(78) |
| Non-Tax Revenue | 49<br>(12) | 3,440<br>(27) | 67,790<br>(34) | 1,48,198<br>(22) |
| Total Revenue | 406 | 12,830 | 2,01,450 | 6,82,212 |
| Receipts | (100) | (100) | (100) | (100) |

**Source:** Government of India; Budget as a Glance, 2010-11 and earlier issues.

**Note:** Pl. update Data

## 13.4 EXPENDITURE OF THE CENTRAL GOVERNMENT

Table 2 summarizes the expenditure of the Central Government for selected years. There has been tremendous increase in the expenditure of the Central Government, particularly in revenue expenditure financed through current taxation and other current non-tax revenues.

**Table 2: Expenditure of the Central Government**

**(Rs. *crores*)**

| Year | Revenue Erpenditure | Capital Expenditure | Total Expenditure |
|---|---|---|---|
| 1950-51 | 350 | 180 | 530 |
| 1980-81 | 14,540 | 9,630 | 24,170 |
| 2001-02 | 3,01,610 | 60,840 | 3,62,450 |
| 2009-10(BE) | 8,97,232 | 1,23,606 | 10,20,838 |
| 2010-11 | 9,58,724 | 1,50,025 | 11,08,749 |

**Source:** Government of India, Budget as a Glance, 2010-11 and earlier issues c.f. Dutt & Sunderam, 2010.

**Note:** Pl. update Data

Before 1987-88, the revenue expenditure of the Central Government was broadly classified into three types, viz., civil expenditure (which included general services, social and community services, and economic services), defence expenditure and grants-in-aid to States and Union territories. At the same time, the Central Government also had adopted another classification of expenditure, viz., development expenditure, defence expenditure and other expenditure.

(a) Under development expenditure, the Central Government included: expenditure on social and community services, on economic services and grants-in-aid to the States and Union territories for development purposes.

(b) Defence expenditure of the Central Government has on armed forces and it included pensions given to the retired armed personnel.

(c) Other expenditure of the Central Government consists of collection of taxes and duties, administrative services, interest payments, pension and other retirement benefits, other grants to the States, etc.

If we add defence expenditure and other expenditure together, we could obtain non-development expenditure.

## 13.5 NEW CLASSIFICATION OF EXPENDITURE

The Central Government adopted a new classification of public expenditure from 1987-88 budget. Under this new classification, all public expenditure is classified into (a) non-Plan expenditure and (b) Plan expenditure.

**Non-Plan Expenditure :** Non-Plan expenditure of the Central Government is further divided into revenue expenditure and capital expenditure.

Revenue expenditure is financed out of revenue receipts, both tax revenue and non-tax revenue. Under revenue expenditure, we include:

(a) Interest payments, defence revenue expenditure, major subsidies (food, fertilisers and export promotion), other subsidies, debt relief to farmers, postal deficit, police, pensions, other general services (organs of state, tax collection, external affairs etc.).

(b) Social services (education, health, broadcasting etc.).

(c) Economic services (agriculture, industry, power, transport, communications, science and technology, etc.) and

(d) grants to states an Union territories and grants to foreign governments.

Capital Non-Plan expenditure includes such items as defence capital expenditure, loans to public eriterprises, loans to States and Union territories and loans to foreign Governments.

It will be seen from Table 3 that non-Plan expenditure, both on revenue and capital accounts, has increased from Rs. 64,500 crores in 1989-90 to Rs. 6,95,689 crores in 2009-2010 (Budget) — increase by nearly 11 times in 10 years.

**Plan Expenditure :** The second major item of Central Government Expenditure is Plan expenditure which is composed of:

(a) Central Plans, such as on agriculture, rural development, irrigation and flood control, energy, industry and minerals, transport, communications, science and technology and environment, social services and others; and

(b) Central assistance for Plans of the States and Union Territories.

It will be clear from Table 3 that Plan expenditure on both revenue and capital accounts was Rs. 28,400 crores in 1989-90 but is expected to touch Rs. 3,63,092 crores in 2010-11 (budget) — a rise by nearly 12.8 times in 11 years.

**Table 3: Total Expenditure of the Central Government**

***(Revenue and Capital Accounts)***

**(*Rs. crores*)**

| | 1989-90 (Actual) | 2010-2011 Budget |
|---|---|---|
| **1. Non-Plan Expenditure** | **64,500** | **7,35,657** |
| On revenue account | 52,130 | 6,43,599 |
| On capital account | 12,370 | 92,058 |
| **2. Plan Expenditure** | **28,400** | **3,63,092** |
| On revenue account | 12,070 | 3,15,125 |
| On capital account | 16,330 | 57,967 |
| **Total Expenditure** | **92,900** | **11,08,749** |

**Note:** Pl. update Data

**Source :** Government of India, Budget as a Glance, 2010-11 and earlier issues. c.f. Dutt & Sundaram, 2010.

### Capital Expenditure and Capital Receipts

Capital expenditure of the Central Government consists of plan expenditure and non-plan expenditure, it is financed out of capital receipts.

The **capital expenditure** of the Central Government consists of:

(a) loans to states and Union territories for financing Plan projects and loans to foreign governments;

(b) capital expenditure on economic development;

(c) capital expenditure on social and community development;

(d) capital expenditure on defence; and

(e) capital expenditure on general services.

The **capital receipts** of the Central Government are composed of:

(i) net recoveries of loans and advances to State Governments and Union Territories and public sector enterprises;

(ii) net market borrowings (i.e. gross borrowings less repayments);

(iii) net small savings collections (gross small savings less States' share); and

(iv) other capital receipts which include provident funds, special deposits, etc.

## 13.6 TRENDS IN EXPENDITURE OF THE CENTRAL GOVERNMENT

Public expenditure in a developing economy has certain notable trends, and Indian public expenditure has shown those trends in a marked manner. Government expenditure in India has been growing very rapidly after 1950-51. Before Independence, there was no planning in India and no effort on the part of Government to establish a welfare state. Public expenditure was, therefore, comparatively small. During the Second World War, government expenditure increased because of the war effort. In the post-war period introduction of planning and the provision by the Government of welfare services in a big way caused public expenditure, both at the Centre and in the States, to increase rapidly.

Moreover, the complexion of expenditure has also been changing very conspicuously. Before Independence, the British Government in India was interested primarily in the defence and civil administration of the country. Therefore, a large part of the expenditure of the Central and State Governments was on these services. Since Independence, increasing participation of the Government in economic life has caused the proportion of development expenditure to the total expenditure to increase rapidly. Defence expenditure has also been rising rapidly due to threat to India's security.

(i) The first major trend in public expenditure which we observe in India (Consult Table 3) is the *growing revenue expenditure of the Government*. From over Rs. 350 crores in 1950-51, the revenue expenditure of the Government of India is over Rs. 8,97,232 crores in 2009-10 (budget). Increased defence commitments, expansion of administration, the working of democratic institutions like the Parliament, the Government's international commitments, increase in Government's participation in nation-building activities like education and public health, rise in prices, etc. — all these are responsible for increased revenue expenditure of the Central Government.

(ii) Non-development expenditure still continues to be a large proportion of the total expenditure. Defence, debt services and administrative expenses are so large and so significant that they are responsible for keeping non-development expenditure at a high level.

(iii) Non-plan expenditure has been rising very fast in recent years - in the 1980's, the annual increase in non-plan expenditure was about Rs. 5,000 crores and in the 1990's the annual increase was over Rs. 10,000 crores. Interest payments, defence expenditure, subsidies and general services — these together form over 90 per cent of non-plan expenditure. What is really serious is that there is absolutely no chance of these four items being kept under check. For instance:

(a) with ever-growing public debt and other liabilides, interest burden of the Central Government is bound to increase over the years, as for example, Rs. 9,250 crores in 1986-87 to Rs. 21,500 crores in 1990-91 and Rs. 2,48,664 crores in 2010-2011 budget. (see Table 4).

(b) defence expenditure is shooting up because of growing tensions in the Indian Ocean region and in Kashmir and the use of highly expensive technology in war equipment - defence expenditure on the revenue account has increased from Rs. 10,870 crores to Rs. 87,344 crores between 1991 and 2011. (see Table 4).

(c) Subsidies on food, fertilisers and on export promotion, have become an integral part of Central Government expenditure and despite Government's frequent promise to reduce them, they are continuing to rise, year after year. Total subsidies rose from Rs. 4,900 crores in 1985-86 to Rs. 12,160 crores in 1990-91 and will be over Rs. 1,16,624 crores in 2010- 2011 (budget estimates); (see Table 4)

(d) The expenditure on general service of the Central government consisting of expenditure on organs of state, tax collection, external services, police, pensions etc. rises every year with wage revisions and periodic increase in dearness allowance. Besides, the Centre has to assist States and Union Territories with grants and assistance for national calamities. The tremendous rise in expenses on administration is a matter of great concern. Consider the following figures (Table 4).

**Table 4 : Non-Plan Revenue Expenditure on Major Selected Items**

(*Rs. crores*)

| | | 1985-86 Actual | 1990-91 Actual | 2010-2011 Budget |
|---|---|---|---|---|
| 1. | Interest payments | 7,500 | 21,500 | 2,48,664 |
| 2. | Defence | 7,000 | 10,870 | 87,344 |
| 3. | Subsidies | 4,900 | 12,160 | 1,16,224 |
| 4. | General, economic social services. | 2,060 | 6,850 | 2,83,425 |
| | **Total** | **24,460** | **51,380** | **7,35,657** |

**Source :** Government of India, Budget as a Glance, 2010-11 and earlier issues.

As mentioned earlier, the total expenditure on these four items alone account for over 77 per cent of the current non-plan revenue expenditure. Unless non-plan expenditure is carefully monitored

and controlled, or unless current revenue is increased proportionally, the Central Government would be *forced to borrow to meet the revenue gap* increasingly and get into a hopeless debt trap.

(iv) Since 1950-51, despite the professed objective of the Government to be interested in economic development and establishment of a Welfare State, the single largest item of expenditure of the country till a few years ago was the defence expenditure. For instance, defence expenditure (revenue and capital) was Rs. 160 crores in 1950-51 and Rs. 1,47,344 crores in 2010-2011 (budget). However, defence expenditure has gone down from 47 per cent of the total expenditure in 1950-51 to 13.3 per cent in 2010-2011 (budget).

(v) Finally, interest payment has now become the single largest item of expenditure (Rs. 2.25,511 crores). This is directly due to extensive borrowing from the market, banks and financial institutions for purposes of development and other needs, and consequent growing burden of debt services. Interest payment was only 11 per cent of current revenue expenditure in 1950-51; it increased to 20 per cent in 1985-86; it is expected to rise to 24 per cent in 2010-11 (budget).

Even though debt services i.e. interest payments — are brought under non- development expenditure, we should recognise their relation to economic development in the country. Since economic planning was initiated in 1950-51, the Government has been borrowing extensively from the market and also from other countries to finance economic development. This was the position till about a decade ago. Since then the Government has been borrowing even to meet its current revenue expenditure. The total public debt and other liabilities of India has gone up from Rs. 2,860 crores in 1950-51 to over Rs. 39,44,598 crores by the end of March 2011. *The increase in debt services is, therefore, the price the country is paying partly for economic growth and partly for wasteful current expenditure.*

**To conclude :** The expenditure of the Central Government since 1950-51 has been influenced largely by two considerations, viz., the necessity to speed up the economic development of the country and keep the country prepared to face threats to its security from foreign aggression. But defence and development are contradictory objectives to follow. To a very large extent India's development effort has been stunted because of the necessity to divert scarce resources for defence needs. In recent years, the Government is burdened with ever increasing burden subsidies and general administration.

**Section - II**

## 13.7 BUDGETS OF STATE GOVERNMENTS[2]

In India, each State Government prepares its own budget of income and expenditure every year. Table 5 summarises the budgetary position of the states since 1951-52.

An important fact revealed by Table 5 is that the receipts and expenditure of the States on the revenue account have been continuously increasing. For instance, in 1951-52, the current revenue of the States was a mere Rs. 396 crores, but it went upto Rs. 16,290 crores in 1980-81 and finally it is expected to exceed Rs. 8,04,943 crores in 2009-2010 (Budget estimates).

The basic reason for this huge increase in state revenues is the necessity to finance the continuously rising expenditure of States which has gone up from Rs. 392 crores in 1951-52 to Rs. 8,37,238 crores in 2009-2010 (Budget). Increase in state revenues over the last five decades are: imposition of new taxes, specially on commodities, rise in the rates of taxes, greater share in Central Government taxes and increasing receipts from the Central Government by way of general and particular grants, etc.

There are many reasons for the increase in the expenditure of the States over the years. The most important reasons are : expansion in civil administration, higher salaries and wages due to rise in

prices and cost of living, increase in the provision of government services in the form of education, public health etc. as well as increased development expenditure.

**Table 5 : Budgets of State Government** (*Rs. crores*)

| *Items* | *1951-52 Actuals* | *1980-81 Actuals* | *2000-01 Actuals* | *2009-10 Budget* |
|---|---|---|---|---|
| **A. Revenue Account** | | | | |
| Receipts | 396 | 16,290 | 2,37,950 | 8,04,943 |
| Expenditure | 392 | 14,810 | 2,91,520 | 8,37,238 |
| **Surplus(+) Deflcit(-)** | **+4** | **+1,480** | **-53,570** | **-32,295** |
| **B. Capital Account** | | | | |
| Receipts | 137 | 5,580 | 1,11,590 | 22,514 |
| Disbursements | 189 | 7.960 | 55,680 | 2,18,540 |
| Surplus/Deficit | -52 | -2,380 | +55,910 | +5,574 |
| Over all Surplus/Deficit | -48 | -900 | +2,340 | -26,721 |

**Source:** RBI, Handbook of Statistics on the Indian Economy 2007-08. RBI, State Finances. A Study of Budgets of 2009-10 c.f. Dutt & Sundaram, 2011.

Note: Tables of this section have been prepared from *RBI Handbook of Statistics on State Government Finances* (2004) and RBI Bulletin February 2008.

The first part of State Budgets is revenue receipts and revenue expenditures. A very interesting point was the swplus revenue over current expenditure which States made regularly for many years in the past. In table 6, current account surplus was Rs. 4 crores in 1951-52 and it rose to 1,480 crores in 1980-81.

Since 1986-87 however, States too, like the Centre have started incurring heavy deficits in their current account. The 2001-2002 state budgets incurred a revenue deficit of Rs. 53,570 crores. Finance Commissions have transferred huge funds from the Centre to the States. Accordingly, states have avoided revenue deficits in recent years. In 2008-09, states expected a revenue surplus Rs. 28,426 crores.

The second part of State Budgets consists of capital receipts of states and disbursements out of them. Capital receipts consist of market loans, borrowings from the Central Government, collecting small savings of the public and provident fund contributions. Capital outlay or disbursements are on various development projects like river valley projects, schemes for agricultural development, etc. As capital revenue was less than capital disbursement, State Government had experienced deficit in the capital account in the first four decades since 1951-52. Later, they had budgeted for larger surpluses in the capital account.

We take revenue deficits and surpluses and capital deficities surpluses together and calculate the over-all surplus/deficit of the states. In 2008-09 budgets, states anticipate a revenue surplus of Rs. 28,426 crores, but a capital deficit of Rs. 25,902 crores — the net over-all surplus is Rs. 2,524 crores.

It would be clear from Table 6 that States have generally managed to get over-all budget surpluses meaning that the aggregate disbursements are below aggregate receipts.

## A Current Revenue of State Governments

State Governments in India collect revenue from different sources to meet their revenue expenditure. Table 6 shows that the important sources of revenue for the States are:

(a) States own taxes states, share in Central taxes,

(b) States shares in the tax proceeds of the Central Government;

(c) grants-in-aid and other contributions from the Centre and

(d) States' own non-tax revenue.

**Table 6: Revenue of the State Governments on Revenue Account (crores)**

| *Items* | *1951-52 Actuals* | *1980-81 Actuals* | *2000-01 Actuals* | *2009-10 Budget* |
|---|---|---|---|---|
| 1. Tax Revenue | 280 | 10,400 | 1, 68,710 | 5.52,243 |
| 2. Non-tax revenue *of which* | 120 | 5,890 | 69,240 | 2,52,700 |
| (a) Grants from the Centre | 30 | 2,620 | 37,780 | 1,68,683 |
| (b) States own non-tax revenue | 90 | 3,270 | 31,460 | 84,017 |
| **Total Receipts (1+2)** | **400** | **16,290** | **2,37,950** | **8,04,943** |

**Source :** RBI, Handbook of Statistics on the Indian Economy 2007-08. State Finances: A Swely of Budgets 2009-10.

## Non-tax Revenue of the States

As indicated earlier, States have two non-tax revenue sources, viz.(a) grants-in-aid from the Central Government and (b) other non-tax revenue.

The Grants-in-aid from the Central Government come in two ways — statutory grants awarded by the Finance Commission and discretionary grants sanctioned by the Planning Commission to finance plan outlays. These grants were expected to mount to Rs. 1,43,030 crores in 2008-2009 (budget).

States own non-tax revenues include interest receipts, dividends from state enterprises and income from general services, social, community and economic services. In 2008-2009 the states' own non-tax revenue would come to ` 66,848 crores.

## B. Revenue Expenditure of State Governments

Under the Indian Constitution, the State Governments have been entrusted with the important. function of maintaining law and order and also with many nation-building activities such as education, public health and medicine, irrigation, agriculture, etc. Like the Union Government, the State Governments too have adopted the policy of building up Welfare States, i.e. raising agricultural and industrial prosperity of the States and looking after the needs of the poor and the downtrodden. A study

of the expenditure of the States since Independence reveals the importance given by them to development as well as to other requirements.

For a long time, since 1951-52, development and non-development expenditure of the states accounted for 50 percent each of the total expenditure. (Table 7). But in the last few years, development expenditure exceeded non-development expenditure. For, example, in 2006 (budget) development expenditure of the states accounted for nearly 57 percent of the total expenditure and non-development expenditure constituted only 43 per cent. Let us now consider the two broad categories of expenditure separately, starting with non-development expenditure first.

## Non-Development Expenditure

Non-development expenditure of the States consists of expenditure on —

(a) the organs of States;

(b) fiscal services (of which collection of taxes and duties are the most important);

(c) interest payments, and servicing of debt which include appropriations for reduction or avoidance of debt;

(d) administrative services;

(e) pensions and miscellaneous general services.

Internal order and security is the responsibility of the State Government and is maintained through the police, judiciary and jails. The police force has been expanded and improved in quality in recent years. Problems of law and order such as communal disturbances, dacoities, industrial dlisputes, etc., have been serious problems and have to be handled carefully. Expansion in governmental activities has led to increase in corruption, which in turn has necessitated the setting up of a special police establishment, the main task of which is to detect and investigate such cases.

**Table 7: Revenue Expenditure of the States**

**(Rs. crores)**

| *Item* | *1951-52 Accounts* | *1980-81 Accounts* | *2008-09 Budget* |
|---|---|---|---|
| 1. Non-development Expenditure | 196 (50%) | 4,090 | 2,60,889 (43%) |
| 2. Development Expenditure | 196 (50%) | 10,510 | 4,45,889 (57%) |
| 3. Grants in Aid of Contribution | -- | -- | 20,376 |
| **Total Expenditure** | **392** | **14,600** | **7,27,164** |

**Source :** RBI, Handbook of Statistics on the Indian Economy 2007-08. State Finances. A Study of Budgets of 2009-10.

The single largest non-development expenditure of the states is payment of interest — for example, in 2008-09 (budget), the states were expected to pay Rs. 1,08,383 crores or 40.3 per cent of the total non-development expenditure is made on interest payments and servicing of debt. These payments are made partly to the Central Government and partly to the market for loans raised.

The second largest item of non-development expenditure is 'pensions'. If was expected to be ` 74.068 crores or 27.6 per cent of the non-development expenditure.

The third largest item of non-development expenditure of the states is on administrative services which included.

(a) Secretarial general services, (b) District administration (c) Police (d) Public works, (e) others (such as public service commission (Treasury and administration, jails, etc.).

The expenditure on administration services was expected to be Rs. 62,906 crores or 23 per cent of the total non-development expenditure.

The expansion of non-development expenditure from Rs. 196 crores in 1951-52 to Rs. 2,60,899 crores in 2009-10 reflects the expansion in governmental activities, problems of law and order and the consequent increase in the police force and continuous upward revision of salaries and dearness allowances (due to rise in price level and cost of living).

### Development Expenditure

Development expenditure is divided into two parts, viz., (a) social and community services, and (b) economic services.

**(a) On Social and Community Services:** Expenditure on social and community services is incurred on such services as education, family planning and public health, housing, labour employment, social security and welfare and natural calamities. These form an essential part of the expenditure of the States. Social services confer a positive advantage on the community, and the more developed these services are the happier and better off would be the people in the country. The States provide free primary education; they also provide facilities for higher education, both school and college. Technical and vocational education also got the attention of authorities because economic development depends a great deal on the availability of trained personnel for industrial undertakings. The expenditure on education has been increasing quite rapidly. Provision of medical facilities and public health is another necessary responsibility of the States. To maintain people in good health will mean keeping the standard of efficiency of workers at a high level and increasing the national income. Establishment and maintenance of dispensaries, hospitals, training and keeping a large staff of doctors, nurses and compounders, public health services for the prevention of disease and similar facilities have to be provided by the States.

**(b) On Economic Services :** Expenditure on economic services consists of expenditure on agriculture, veterinary and co-operation, irrigation, electricity, rural and community development projects, civil works, industries and minerals, etc. Agriculture is the most important economic activity in the country providing employment to nearly 70 per cent of the population. Large outlays on it are, therefore, for the economic development of the country. Since 1951, community development projects have been implemented with the objective of improving rural life. Civil works include road development, construction of public buildings, etc. A network of roads is essential for trade and economic prosperity. Civil works are sometimes undertaken to provide employment to persons during periods of famine or business depression.

The single most important item of development expenditure is education which accounts for about 34 to 35 per cent of the total development expenditure. The next important item of development expenditure is agriculture and allied services including irrigation.

**Table 8 : Growth of State Expenditure : Revenue & Capital**

***(Rs. Crores)***

| | **Revenue Expenditure** | **Capital Expenditure** | **Total State Expenditure** |
|---|---|---|---|
| 1951-52 | 303 | 189 | 582 |
| 1955-56 | 604 | 336 | 940 |
| 1960-61 | 990 | 633 | 1623 |
| 1965-66 | 1892 | 1324 | 3216 |
| 1970-71 | 3390 | 1783 | 5173 |
| 1980-81 | 14800 | 7962 | 12770 |
| 1986-87 | 35960 | 9390 | 45350 |
| 1990-91 | 71797 | 19491 | 91280 |
| 1995-96 | 145004 | 32580 | 177584 |
| 2000-01 | 291522 | 55677 | 347199 |
| 2003-04 | 377681 | 148342 | 526023 |
| 2005-06 | 471437 | 133914 | 610751 |
| 2006-07 | 514952 | 144578 | 659530 |
| 2007-08 | 606216 | 181273 | 787489 |
| 2008-09 | 691409 | 201374 | 892783 |
| 2009-10 | 7,12,413 | 2,56,224 | 968647 |

**Source :** Budgets of States.

Table 8 shows that Revenue Ecpendture of States had grown at faster pace.

## D. Trends in Revenue Expenditure of States

We may notice some broad trends regarding expenditure of States. Some of these trends are observed in the case of the Union Government also.

*In the first place*, there has been rapid increase in current or revenue expenditure. From Rs. 392 crores in 1951-52, revenue expenditure of states went up to Rs. 14,810 crores in 1980-81. The budget for 2008-09 has placed revenue expenditure of states at Rs. 6,91,401 crores. This rapid expansion is to be expected — with rise in salaries, expansion in government activities, growing interest payment pensions etc.

*Secondly***,** there has been a change in the composition of public expenditure of states. For one thing, development expenditure has become more important than non-development expenditure. In 1951-52, both types of expenditures were exactly equal, i.e. 50:50. But in the 2008-09 budget, development expenditure was about 62 per cent and non-development expenditure was about 38 per

cent of the total expenditure. Moreover, some items of development expenditure have increased much more than others. For instance, expenditure on education has increascd the most.

*Thirdly*, State Governments finance economic development partly through capital receipts which consist of market loans, borrowings from the Central Government, small savings etc. The items included in the development projects of States are multi-purpose river-valley projects, irrigation and navigation, schemes for agricultural development and research, electricity schemes, road transport, roads and water works, industrial development, etc.

As we have mentioned earlier, State Governments have taken many *policy initiatives* to augment revenues as well as control and curtail their non-development expenditure. Important steps taken by them since 2000-01 are as follows :-

(a) Some states have proposed curtailment of non-development expenditure by not filling vacated posts, adoption of austerity measures and reduction of non-plan expenditure.

(b) Many states have introduced new pension schemes based on defined contribution — the objective is to restrict rising pension obligations.

(c) In terms of expenditure, many states have raised expenditure on education and health sectors and on implementing Centrally sponsored rural employment guarantee scheme.

(d) Several state Governments have proposed substantial enhancement of outlays for social schemes, particularly for the weaker sections.

## III. TRENDS IN REVENUE AND EXPENDITURE OF CENTRAL AND STATE GOVERNMENTS

We have explained the trends in revenues and expenditure of Union and State Governments separately. We may, however, give a combined picture of the total revenue and expenditure of the Centre and the States Union Territories. (Table 9).

**Table 9: Budgetary Transactions of the Central and State Governments and Union Territories**

***(Rs. Crores)***

| | 1960-61 | 2008-09 (BE) |
|---|---|---|
| 1. Development Expenditure | 24,430 | 8,34,345 |
| 2. Non-development Expenditure* | 12,420 | 6,51,190 |
| 3. Total Expenditure | 36,850 | 14,85,535 |
| 4. Total Revenue | 24,570 | 12,08,804 |
| 5. Gross Fiscal Deficit | 12,280 | 2,76,731 |
| 6. Net Capital Receipts | 8,830 | 2,79,526 |
| 7. Over all deficit | -3,450 | 2,795 |

* This Includes disbursements as compensation and assignments to local bodies and Panchayati Raj institutions and other adjustments.

In less than five decades between 1960-61 and 2006-07, the combined total expenditure of the Centre and the States had risen from Rs. 36,850 crores to Rs. 14,85,535 croteS, that is, by over 40 times. Now, the combined total expenditure of the Central and the States consists of

(a) Development expenditure; (b) Non-developmental expenditures of all types; an (c) Compensation and assignments made by the States to local governments and Paxkchayati R institutions.

During the same period, the combined currtnt revenue receipts of the Centre and the States rose from Rs. 24,570 crores to Rs. 12,08,804 crores.

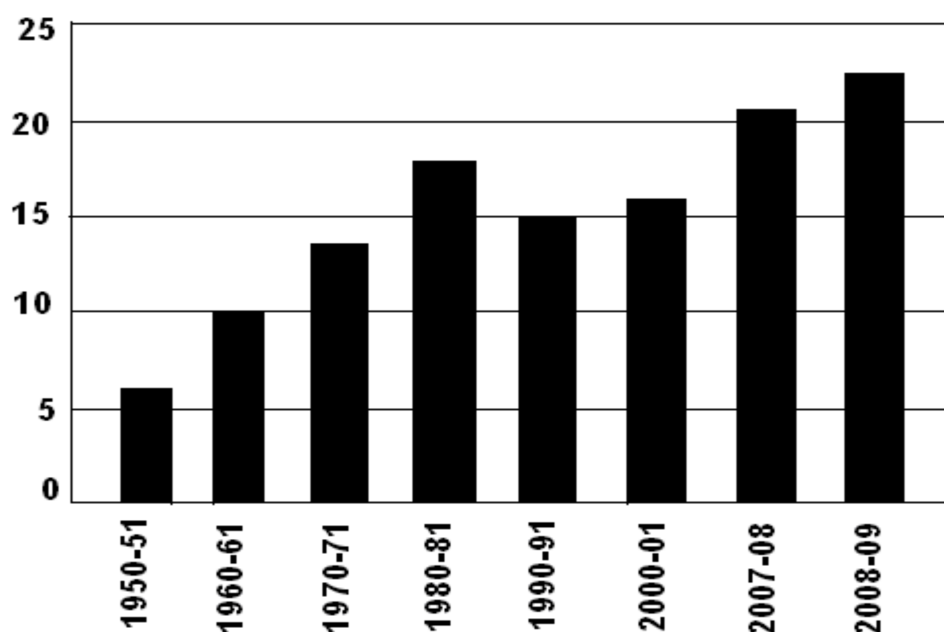
Total revenue consists of (a) Tax revenue of the Centre and of the States, (b) non-tax receipts of the Centre and the States, and (c) non-debt capital receipts consisting of loans and advances.

Now, the combined total expenditure always exceeded the combined total current receipts, resulting in a gap, known as gross fiscal deficit. The 2008-09 budget estimated gross fiscal deficit at Rs. 2,76,731 crores. This gap is financed largely through capital receipts i.e.

(a) Internal receipts: Borrowings from the market, mobilisation of small savings. provident fund collections, etc; and

(b) External loans and grants from foreign governments, international institutions and commercial borrowings.

**Taxes in India (Central and States and Union Territories) as per cent of GDP**




Whenever these capital receipts were found inadequate to meet the gap (fiscal deficit), the Government left it uncovered; this was formerly designated as over-all budget deficit. This was taken as the extent of deficit financing by the Government for a long time.

This concept of deficit was given up. Since April 1997, the Finance Ministry, of the Government of India discontinued the system of adhoc Treasury Bills and 91-day tap treasury bills and with that the concept of conventional budget deficit lost its relevance. *The amount of fiscal deficit of the Government is fully covered by an equal amount of capital receipts*, as far as the Centre is concerned. Accordingly, there is no over-all budget deficit for the Centre. And in the year 2008-09 there is surplus in the budgetary transaction of the central and state governments. This surplus belongs to the state governments. If instead there happens to be a deficit that would also belong to states.

During this period both development expenditure and non-development expenditure have increased quite fast, partly because of expansion in government activities and partly because of inflation. However, the increase in non-development expenditure is much faster. The increase in defence expenditure, major subsidies and expenditure on administration may be specially mentioned here. Despite much boasting by the Government about the use of budget for development purposes, we find that the ratio of non-development expenditure to development expenditure is around 48:52.

**Self Assessment Question**

Q. 1 Differantate between internal debt and external debt.

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## 13.8 PUBLIC EXPENDITURE MANAGEMENT : JUSTIFICATION AND NEED

On account of growing burden of non-development expenditure, the fiscal situation deteriorated throughout the 1980s and assumed crisis proportions by the beginning of 1991-92. Throughout the 1980s all the indicators of fiscal imbalance clearly reflected that it was on the rise. *The indicators which are often considered to assess the fiscal imbalance are the reuenue deficit and the gross fiscal deficit*. The revenue deficit refers to the difference between revenue receipts and revenue expenditure. This measure of fiscal imbalance does not completely reflect the structural imbalance in the fiscal operations of the government. The fiscal deficit reflects the total resource gap which equals the excess of total government expenditure over government revenue and grants.

An important justification for expenditure management in the period since 1991 (known as the period of economic reforms) was that the fiscal deficit must be reduced since it was considered to be a source of instability for the economy. The policymakers relied on three arguments to cut down gross fiscal deficit of the Central government which was as high as 7.55 per cent of GDP during 1985-90. Over this period, the revenue deficit was also as large as 2.37 per cent of GDP. *First* the government assuming that a fiscal deficit is inherently problematic argued that it can be inflationary or may cause external deficits. *Second*, it is asserted that large fiscal deficits will reduce more desirable private investment by reducing the availability of investible resources and raising the interest rate on borrowing. *Third*, fiscal deficits result in accumulation of public debt and the increased future interest obligations of the government, and are thus not sustainable.

Though validity of these arguments has always been in doubt, the Central Government nonetheless attempted to reduce the fiscal deficit in the period of economic reforms.

The fiscal deficit of the Central Government could be easily cut by pursuing a discreet taxation policy. But the overall economic reform policy did not permit the government to follow this route. *The burden of the fiscal deficit correction therefore fell on public expenditure management.*

### A. Lowering Ratio of Public Expenditure to GDP

In an inflationary economy, public expenditure in absolute terms cannot be reduced. Hence, the government did not aim at it. The government nevertheless sought to curtail general expenditure. Issues of allocative and technical efficiency in the design and implementation of public expenditure received scant attention. While there was virtually no attempt to curb extravagance on the part of

ministers and bureaucrats, development expenditure was drastically curtailed. Moreover, there has been official commitment to downsizing the government. In totality the expenditure policy of the government lacked both rationality and direction and thus the ratio of public expenditure to GDP was 28.6 per cent in, 2008-09, almost the same as in 1990-91. From 1991-92 for seven years the ratio of public expenditure to GDP registered a modest decline. In 1997-98 this ratio had fallen to 25.0 per cent. Thereafter, the trend was reversed as the ratio of public expenditure to GDP rose to 28.0 per cent in 2000-01, to 28.5 per cent in 2003-04 and further to 29.1 per cent in 2009-10.

**B. Falling Capital Expenditure - GDP Ratio**

The really disconcerting feature of the expenditure of the Central government was that it did not get reduced as was intended. The main problem by the end of the 1990s was that while revenue expenditure — GDP ratio stagnated around 13 per cent, there was a steep reduction in capital expenditure-GDP ratio.

A careful study of public expendjture to GDP ratios (per cent) given in Table 10 shows that from 1990-91 to 1996-97 **the revenue expenditure-GDP ratio** decreased. Thereafter, it steadily increased and stood at 12.8 per cent in 1999-2000. Therefore, as far as revenue expenditure-GDP ratio is concerned, by the end of the 1990s the government was exactly where it was in 1990-91. In this decade, the interest payments-GDP ratio steadily rose from 3.8 per cent in 1990-91 to 4.6 per cent in 1999-2000. Therefore, ratio of net **revenue expenditure (that is RE—IP) to GDP** declined only to the extent the interest payments GDP ratio rose during the 1990s. The reduction in **capital expenditure-GDP ratio** however is strikingly large in the period. The capital expenditure-GDP ratio was 4.4 per cent in 1990-91. It declined steadily throughout thereafter and stood at only 2.5 per cent in 1999-2000 and 1.9 per cent in 2009-10. It is thus clear that *the burden of Fiscal imbalance correction during the period of economic reforms has been primarily on capital expenditure*. This approach of the Central government is questionable. Reducing expenditure on transport and infrastructure development both in urban and rural areas has disrupted the growth process. Reduced capital expenditure in real terms over the years has become such a constraint that it unreservedly dampens investment activity in the private sector. This has caused a setback to overall growth process particularly at a time when the State has dramatically withdrawn from directly productive activity.

## Curtailing Subsidies

Direct subsidies on food, fertiliser, and export which accounted for 2.2 per cent of GDP in 1990-91, declined to 1.3 per cent in 1996-97 and fluctuated around that level during the last five years of the decade. *Subsidies accounted for 1.4 per cent of GDP in 2007-08 and 1 9 per cent of GDP in 2009-10*. The export subsidies were eliminated by 1992. The government thus aimed at reducing food and fertiliser subsidies. Food subsidies were cut through increases in prices of foodgrains issued through the public distribution system. This policy denied access to food to many poor household and thus involved heavy social cost. Accordingly, the government has started providing foodgrains to the people below poverty line at highly subsidised rates under TPDS (Targeted Public Distribution System). As a result, the burden of food subsidy has increased. Fertiliser subsidies which accrue directly to the fertiliser industry were also sought to be cut. Since reduction in fertiliser subsidy entailed rising prices faced by the farmers, the use of fertilisers remained restricted arresting growth of agriculture production.

**Table 10**
**Central Governments Expenditure to GDP Ratios: 1990-91 to 2009-10**
(Per cent)

| Year | RE/GDP | IP/GDP | CE/GDP | Net RE/GDP |
|---|---|---|---|---|
| 1990-91 | 12.9 | 3.8 | 5.6 | 9.1 |
| 1991-92 | 12.6 | 4.1 | 4.5 | 8.5 |
| 1992-93 | 12.3 | 4.1 | 4.0 | 8.2 |
| 1993-94 | 12.5 | 4.2 | 3.9 | 8.3 |
| 1994-95 | 12.0 | 4.3 | 3.8 | 7.7 |
| 1995-96 | 11.7 | 4.2 | 3.2 | 7.5 |
| 1996-97 | 11.5 | 4.3 | 3.1 | 7.2 |
| 1997-98 | 11.8 | 4.3 | 3.4 | 7.5 |
| 1998-99 | 12.4 | 4.5 | 3.6 | 7.9 |
| 1999-00 | 12.8 | 4.6 | 2.5 | 8.2 |
| 2000-01 | 13.2 | 4.7 | 2.3 | 8.5 |
| 2001-02 | 13.2 | 4.7 | 2.7 | 8.5 |
| 2002-03 | 13.8 | 4.8 | 3.0 | 9.0 |
| 2003-04 | 13.1 | 4.5 | 4.0 | 8.6 |
| 2004-05 | 11.9 | 3.9 | 3.5 | 8.0 |
| 2005-06 | 11.9 | 3.6 | 1.8 | 8.3 |
| 2006-07 | 12.0 | 3.5 | 1.6 | 8.5 |
| 2007-08 | 12.0 | 3.5 | 2.4 | 8.5 |
| 2008-09 | 14.2 | 3.5 | 1.6 | 10.7 |
| 2009-10 | 14.5 | 3.5* | 1.9 | 11.0 |

* According to *Economic Survey* 2010-11, interest payments in 2009-10 were 3.9 per cent of GDP.

***Note:*** RE = Revenue expenditure

CE = Capital expenditure

IP = Interest payments

Net RE = RE - IP

**Source:** Reserve Bank of India, *Handbook of Statistics on the Indian Economy. 2009-10* (Mumbai, 2010), Table 234, p. 422.

### Stubborn Interest Payments

Interest payments have been the single largest component of the revenue expenditure and are the result of past borrowings. Interest payments were sought to be reduced by reducing a part of the public debt. But the performance of the government on this front has been dismal. Interest payments as a proportion of GDP rose from an average of 3.2 per cent during 1985-90 to an average of 4.1 per cent during 1990-95 and climbed to 4.7 per cent in 2000-01. In 2009-10, they were 3.2 per cent of GDP. Interest payments are estimated to have absorbed 46.1 per cent of total tax receipts (net to Centre) in

2009-10 as against 50.0 per cent in 1990-91 and 72.7 per cent in 2000-01. Since interest payments entail a large claim on public revenues and impair the government's capacity to meet necessary expenditures, their earnest management deserves far more serious commitment. So far the Central government's management of public expenditure has been lack lustre, as a result of which the burden of interest payments remains heavy.

## 13.9 RECOMMENDATIONS OF EXPENDITURE REFORMS COMMISSION (ERC)

The Centre set up an Expenditure Reforms Commission in February 2000 as part of the Union Budget proposals to look into ways and means of reducing wasteful government expenditure, and to suggest ways and means for reducing the functions, activities and administrative structure of the government.

The Commission is headed by the former Finance Secretary, Mr. K.P. Geethakrishnan. The Commission has also been asked to:

- To foster convergence, avoid overlap in the functions of different Central Government ministries and departments and take a relook at the role of the State Governments.
- To review the need to continue with subsidies, both explicit and implicit, and suggest measures for maximising its impact on the target population at minimum cost, determination of user charges for departmental and commercial units as well as devise strategies to recover costs by levying user charges.
- To review the problem of overstaffing of central ministries and attached offices. To make proper arrangements for retraining and redeployment of surplus manpower. Commission has been given the power to review the procedure for setting up government-funded autonomous institutions as well as the pattern of funding and suggest measures for effecting improvement and reducing budgetary support for their activities.

Expenditure Reforms Commission (ERC) has submitted three reports so far for downsizing six ministries and departments. The first report submitted on July 10, 2000, dealt with Food Subsidy. The report contains a road map for

(i) restructuring of the Public Distribution System (PDS);

(ii) reduction of Food Corporation of India's carrying costs;

(iii) restructuring of the minimum support price (MSP) to the farmers;

The Second report, is in four parts dealing with

(i) Rationalising fertilizer subsidy;

(ii) Optimising Government staff strength;

(iii) Rationalisation of the Functions, Activities and Structures in the Ministry of coal;

(iv) Ratjonalisation of the Functions, Activities and Structures of the Ministry of Information and Broadcasting.

The recommendation of the first report regarding modification of economic cost of wheat and rice has been implemented. The second report which is in four parts, is under examination of the concerned Ministers or Departments.

The ERC has submitted its third report, which is exclusively dealing with the crucial Department of Economic Affairs (DEA) for the rationalisation of its structure.

## A. MAJOR RECOMMENDATIONS OF EXPENDITURE REFORMS COMMISSION

- **Food Subsidy**

With a view to reduce subsidy on food, ERC has suggested series of measures which include:

1. Efforts to ensure that quantities allocated for below the poverty line (BPL) population reach them at the prices at which the Government of India releases. To this end, State Governments would need to identify BPL, population in a transparent manner.
2. In those States where the total distribution under the PDS is in excess of the quantities earmarked for BPL population and at prices at or below the price at which the sales are to be made to the BPL population, the Government of India could provide the subsidy amounts directly to the State Governments, leaving it to them to procure the foodgrains required for the BPL population.
3. A National Food Security buffer stock of 10 million tonnes-4 million tonnes of wheat and 6 million tonnes of rice-should be maintained at all times.
4. The cost of buffer stocks held in excess of the above requirements should be treated as "producer's subsidy" and action taken to phase it out over the next three years through. (i) moderating the increase in minimum support prices and; (ii) moving towards procurement of single (common) variety of paddy/rice, as in the case of wheat. Besides, through a suitable adjustment in the pricing mechanism, reduce procurement of paddy and increase procurement of rice through a levy system; (iii) Encouraging State Governments and private sector to enter procurement, trade and export of foodgrains through an assurance of continuity of policy over the next 15 years. The objective of the procurement policy should be to maintain a Food Security Buffer of 10 million tonnes and availability of 21 million tonnes per annum for distribution through the PDS. Thus the total average stocks to be maintained for distribution and buffer stock should he no more than 17 million tonnes or so compared to a likely level of 24 million tonnes in the current year.
5. Every effort should be taken to minimise FCI's overhead charges and the methodology for allocation of FCI's overheads as between distribution and buffer stocks needs to be modified to ensure that the consumers particularly those below poverty line are not made to pay for the cost attributable to excess stocks or FCI's inefficiencies.

**B. Rationalizing Fertilizer Subsidies**

The Retention Price Scheme (RPS) has led to the development of a large domestic industry and near self-sufficiency. However, the unit wise RPS is a cost plus scheme. It results in high cost fertilizers, excess payments to industry and provides no incentives to be cost efficient. Besides, fertilizer subsidies have grown over the years. The package, suggested to rationalise fertilizer subsidies takes care of the needs of small farmers and proposes to bring fertilizer prices to the level of import parity price in a gradual and phased manner over a period of time as follows:

1. To protect small farmers and marginal farmers who consume a large part of their output from a loss in their real incomes arising out of increase in farm gate prices of fertilizers two options are suggested:
   (a) introduction of a dual price scheme under which all cultivator households are given 120 kgs. of fertilizers at subsidized prices and;
   (b) expansion of Employment Guarantee Scheme and Rural Works Programmes to provide additional incomes to small farmers.

2. Dismantling of the control system in a phased manner, leading to a decontrolled fertilizer industry which can compete with import albeit with a small level of protection and a feedstock cost differential compensation to naphtha/liquified natural gas (LNG) based units to ensure self-sufficiency.

3. The ERC recommends a 7 per cent increase in the price of urea in real terms every year from 1.4.2001. With this order of increase *open market price will reach* Rs. *6,903 per tonne by 1.4.2006*, a level at which the industry can be freed from all controls and be required to complete with imports, with variable levy ensuring availability of such imports at the farm rate of Rs. 7,000 per tonne of urea. While no concessions will be necessary from this date onwards for gas based, fuel oil/light sulphur heavy stock and mixed feed stock plants, existing naphtha plants converting to LNG as also new plants and substantial additions to existing plants will be entitled to a feed stock differential with that for LNG plants serving as a ceiling.

4. The farm gate prices of *nitrogenous, phosphatic and potassic* fertilizers should be set to promote a desired balance of fertilizer use. In the circumstances it is suggested that once urea price is re-determined every six months, the prices of potassic and phosphatic fertilizers should be suitably adjusted to ensure the desired NPK balance. It will be useful if government could announce in advance the formula to be adopted for fixing the prices of P & K fertilizers with reference to a given urea price.

## C. Optimising Government Staff Strength

1. A cut of 10 per cent on the staff strength on 1.1.2000 to be carried out by the year 2004-05. Besides, an annual direct recruitment plan for all cadres to be prepared by a Screening Committee.

2. There should be a total ban on creation of new posts for two years.

3. Staff declared surplus should be transferred to the Surplus Cell to be redesignated as the Division Retraining and Development, which will pay their salary, retirement benefits etc.

4. Surplus staff should be made eligible for a liberal Voluntary Retirement Scheme recommended by the Fifth Central Pay Commission with the exception that commutation entitlements will be as a present and the *ex-gratia* amount will be paid in monthly instalments covering a five year period.

5. Those who do not opt for Voluntary Retirement Scheme and are not re-employed within one year will be discharged from service.

## D. Downsizing of Government

The term downsizing of Government simply indicates reducing the size of Government machinery. The policy of downsizing of Government has been adopted by the Government of India to reduce the size of its administrative machinery on a rational basis. The Central Government is also pressurizing the State Governments to follow the policy of downsizing of government at the State level and accordingly some State Governments had already signed Memorandum of Understanding (MOUs) with the Central Government in this regard. The expenditure Reforms Commission (ERC), in its second report, submitted its recommendation on optimising the Government staff strength, which can be considered as one of the basis for downsizing the government.

The Government is of the opinion that downsizing of the government administration will not result in much fiscal saving rather it will eliminate bureaucratic controls arid change the anachronistic control mentality of the system. The budget, 2001-2002 has taken some active steps for downsizing various government departments.

In this connection Economic Survey, 2000-2001 observed. The primary purpose of such downsizing is to eliminate bureaucratic controls and to change the anachronistic command mentality still prevalent in the system. Accordingly, all employee positions of this nature must be identified and eliminated. For this to be truly effective and sustained, divisions, departments and ministries, whose primary purpose was to control and direct the economy, must be abolished. Once this is done, the Government will be forced to become a facilitator of economic growth and investment. It can then sharpen its focus on the provision of public goods and critical non-commercial segments of infrastructure, much of which is in rural areas where a majority of the poor live."

## 13.10 SUMMARY

In this lesson we have read about expenditure of central and state government of India, their budgets; public expenditure management and Expenditure Reforms Commission.

## 13.11 REFERENCE


1. Misra & Puri (2015), *Indian Economy*, Himalaya Publishing
2. Datt & Mahajan, *Indian Economy*, S. Chand Publications.


## 13.12 FURTHER READINGS


1. Misra & Puri (2015), *Indian Economy*, Himalaya Publishing
2. Datt & Mahajan, *Indian Economy*, S. Chand Publications.


## 13.13 MODEL QUESTIONS

1. Describe trends in Centre and State Public Expenditure of India.
2. Discuss Expenditure Reforms Commission.

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# CENTRAL STATE FINANCIAL RELATIONS IN INDIA

**Structure**

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## 14.0 OBJECTIVES

After going through this lesson, you shall be able to:

- understand the central and state financial relations in India.
- differentiate between the criteria being followed by the Finance Commission and the Planning Commission for devolution of financial resources.
- acquire information about constitutional provisions on division of tax powers between central and state governments.
- identify the reasons for conflict between central and state governments in sharing the financial resources.
- suggest measures for the improvement of central state financial relations in India
- answer model questions

## 14.1 INTRODUCTION

Federal political organisations involve distribution of powers and responsibilities between federal (central) and (provincial) state governments. When gaps between needs and resources appear they are sought to be filled through federal fiscal transfers. But the size of the divisible pool and the criteria for devolution of resources has often given rise to a good deal of controversy. In this lesson we will study about the sharing of resources between the centre and states in India and the basis of sharing these resources.

## 14.2 RESOURCE SHARING

Thinkers are not unanimous about the proportion of share and the devolution criteria. Buchanan (1949) argued that the equity approach i.e. states equal in respect of some relevant circumstances should be treated equally; whereas Scott (1950) supported efficiency approach. Lefebvre (1962) felt that, 'derivation and need 'have been the most common basis for federal fiscal transfers. 'Derivation' refers to the origin of certain sources of resources assigned to the federal government, whereas 'need' refers to the needy states. These needy states should receive more of resources from the federal government. India considers all the approaches for devolution of resources.

### 14.2.1 Vertical and Horizontal Imbalance

Emergence of imbalances between functional responsibilities and financial resources of different tiers of government is a characteristic feature of all federations. Even in old federations (United States, Australia and Canada), financial conflicts between national and sub-national governments persists. India is a federal country; the federal structure has made a clear cut distinction between the union and state functions and also sources of revenue. Indian constitution vested more financial powers with elastic sources of revenue to the central government, whereas states are vested with limited financial powers and inelastic revenue sources, this is called the existence of vertical imbalance. There are another type of imbalance called horizontal imbalance i.e. states are differ in economic status so that provision of public goods and services would also differ. Imbalance arises between functional responsibilities and financial resource, calling for transfer of resources from the centre to the states to correct both vertical and horizontal imbalances. Musgrave put it as realization of horizontal equality however it is unlikely that rich states within a country will voluntarily agree to transfer adequate resources to the resource deficient poor states. On an average, the revenue of states from their own resources is sufficient only to meet 50 to 60 percent of their current expenditure in India. Since the insufficiency of the state's fiscal resources had been foreseen at the time of framing the Constitution, hence a mechanism is established for devolution of resources.

### 14.2.2 Division of Tax Powers

India is a quasi federal system with more power concentrated at the central level and has more legislative power. Flexibility and objectivity in revenue-sharing between the union and the states are the important features of the constitutional scheme. Sources of revenue with the union are not entirely meant for its exclusive use but are to be shared with the states. Resources transfer is needed for the correction of financial gap ('gap-filling') to ensure national minimum standards in providing public goods and services by the provincial governments which have been explained later in detail. Transfers of resources can be in the form of (a) Tax sharing (b) Grants- in- aid and (c) Loans. These transfers can be made by constitutional arrangements and political bargaining. Constitution of India makes clear division of fiscal powers between the union and the states. The principles adopted for this classification is that taxes which have an interstate base are being levied by the union; those with local base are being levied by the states. The residuary powers belong to the union. Indian constitution neither indicates the share of states in the divisible pool of central taxes nor prescribes any principles (criteria) for the distribution. The reason often given is the expected changes in the sphere of taxation and public

expenditure.

### A. Union Tax Powers in India

Distribution of taxation powers between the centre and the states is meant to minimise tax problems in a federal setup such as double taxation, tax rivalry among the states, duplicate tax administration and tax evasion. ***Article 246 (seventh schedule) of the Indian constitution or List I****deals* with union's exclusive powers to legislate in respect of the matters from entries 82 to 92 C pertains to taxation powers. Thirteen taxes are listed in centre's list, these are viz... taxes on income other than agricultural land, customs duties, duties of excise except those on alcoholic liquor for human consumption, corporation tax, estate duty in respect of property other than agricultural land, terminal taxes on goods and passengers carried by railways, sea or air, taxes other than stamp duty on transactions in stock exchanges and futures markets and taxes on sale and purchase of goods other than newspapers, when such sale takes place in the course of inter-state trade or commerce.

There are four categories of central taxes with regard to levy, collection, and appropriation viz...

1) Category I: These are levied, collected and entirely retained by the union govt.
2) Category II: These are levied and collected by the union govt. but are shared with the states.
3) Category III: These are levied and collected by the union govt. but wholly retained by the states.
4) Category IV: These are levied by the union govt. collected and retained by the states.

The Constitution of India was amended to provide a prescribed percentage of the revenue receipts to be transferred to states ***(Article 270(2).*** However, surcharges and cesses do not form part of the divisible pool. Cesses are intended for specific purposes and the states can have no complaint if the money is spent on predetermined purposes. Keeping in view the complexity of the present national and international situation which has placed additional burden on the union, the finance commission would not recommend any constitutional amendment to make surcharges shareable.

### B. Tax Powers of Indian States

***List II, article 45 to 63*** specify the taxation powers of the state government. Nineteen taxes are listed in the State List. The important taxes listed in the state list are land revenue, taxes on agricultural income, taxes on land and buildings, taxes on mineral rights subject to restrictions imposed by Parliament, duties of excise on alcoholic liquor for human consumption, taxes on sale and purchase of goods other than newspapers, taxes on goods and passengers carried by road, taxes on vehicles, taxation on professions, taxes on luxuries including on entertainments, taxes on entry of goods into a local area and taxes on advertisements other than those published in newspapers and broadcast by radio or television.

***List III*** does not contain any head of taxation which means union and the states have no concurrent powers of taxation. The residuary power of taxation is vested in the Union government.

### 14.2.3 The Enhancement of States' Revenue Share

The Constitution (Eightieth Amendment) Act, 2000, significantly changed the manner of distribution of central tax collections between the central and state governments. Prior to this amendment, income tax and union excise duties were the only taxes shared with the states. This amendment altered the pattern of sharing of central taxes between the centre and the states by providing for the sharing of the net proceeds of all union taxes and duties with the states. Still further, the constitution (Eighty-eighth Amendment) Act, 2003 has included 'taxes on services' under entry 92C

in the ***union list I*** in the seventh schedule of the constitution.

### 14.2.4 Service Tax

Service tax is being levied by the centre under its *residual* powers relating to subjects that are not specified in any of three lists in the seventh schedule to the constitution. With the 88$^{th}$ Amendment of the Constitution, service tax was brought under the purview of article 268 a (3) under the union list. ***Article 268*** provides that taxes on services shall be levied by the Government of India and such tax can be collected and appropriated by the Government of India and the states. The service tax was initially introduced on three services in 1994 and its gradual extension to other services was a major development in the area of indirect taxation in the country. During recent period, services have emerged as the dominant component (52%) in the Gross Domestic Product (GDP), yet there is no mention in the Constitution enabling any level of government to tax services. The Union has used the residuary power to levy taxes on selected services.

### 14.2.5 Borrowings

The executive power of the Union extends to borrowing upon the Consolidated Fund of India within the limits, if any as may from time to time be fixed by Parliament by law and to the giving of guarantees within such limits, if any, as may be so fixed. Similarly, the executive power of a state extends to borrowing upon the Consolidated Fund of the State within such limits, if any, as may from time to time be so fixed by the state legislature. However, the executive power of the states extends to borrowing within the territory of India only subject to some restrictions.

Under ***Article 293*** of the Constitution, State Governments require the approval of the Centre for borrowing from the market, if they are indebted to the Centre. The Centre has been setting the limits on the market borrowings of States as part of the overall pattern of plan financing. States have been complaining from time-to-time that their share in overall market borrowings has come down significantly

## 14.3 MECHANISMS FOR DEVOLUTION OF RESOURCES

Intergovernmental transfers are an integral part of a multilevel fiscal system; such transfers are justified through different channels on horizontal and vertical equity and efficiency considerations. These channels are explained under various sub-headings.

### 14.3.1 Finance Commission

According to ***Article 280*** of the Indian constitution, president appoints Finance Commission for every five years. Finance Commission is a Constitutional semi *judicial body* entrusted with twin responsibilities of allocating central government revenues between the centre and the states on the one hand and among the individual states on the other to address both vertical and horizontal imbalances. The duties of the Finance Commission as prescribed under this Article are, (a) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them and the allocation between the States of the respective shares of such proceeds, (b) the principles which should govern the grants-in-aid out of the Consolidated Fund of India, (c) the measures needed to augment the Consolidated Fund of a State to supplement the resources of the panchayats and municipalities in the state, and any other matter referred to the commission by the President in the interests of sound finance.

*Vertical imbalance*: Central government revenue resources are more elastic and functions are inelastic, whereas state government resources are less, inelastic and functions are elastic it is called as vertical imbalance.

*Horizontal imbalance*: States are differing in income levels, revenue mobilisation and differ in providing public goods.

Under **Article 281**, every recommendation made by the Finance Commission together with an explanatory memorandum as to the action taken thereon is required to be laid before each house of Parliament (Rajya Sabha and Lok Sabha). The recommendations of finance commission theoretically not a binding, although there has been no case so far when the Government of India has deviated from recommendations of successive finance commissions. It has been suggested that the Constitution itself should describe the recommendations as an award binding on both the union and the states.

A. **Devolution Criterion In Lieu of Income Tax:** Finance commission has made a significant contribution towards correcting, to some extent the disequilibrium of resources not only between the union and the states but also between the states interse. The first finance commission was appointed in 1951 under the chairmanship of K.C. Niyogi for the period 1952-57. So far 12 finance commissions have been constituted and reports have been implemented. At present 13th finance commission's award is under the progress of implementation (Table 14.1).

**Table 14.1**

**India's Finance Commissions (1952-2015)**

| Finance Commission | Year of Appointment | Chairperson | Period of Duration |
|---|---|---|---|
| I | 1951 | K.C. Niyogi | 1952-57 |
| II | 1956 | K. Santhanam | 1957-62 |
| III | 1960 | A.K. Chanda | 1962-66 |
| IV | 1964 | P.V. Rajamannar | 1966-69 |
| V | 1968 | M. Tyagi | 1969-74 |
| VI | 1972 | B.N. Reddy | 1974-79 |
| VII | 1977 | J.M. Shellat | 1979-84 |
| VIII | 1983 | Y.B. Chavan | 1984-89 |
| IX | 1987 | N.K.P. Salve | 1989-95 |
| X | 1992 | K.C. Panth | 1995-2000 |
| \XI | 1998 | A.M. Khusro | 2000-05 |
| XII | 2003 | C. Rangarajan | 2005-10 |
| XIII | 2007 | Vijay Kelkar | 2010-2015 |
| XIV | 2012 | Y.V.Reddy | 2015-20 |

**Source: -** Various Finance Commissions, Govt of India.

The Finance Commissions have not recommended uniform 'share' and uniform criterion regarding the share of the states out of union tax revenue and the governing principles in this regard (Table 14.2).For the first time the **Eighth Finance Commission** introduced a new formula for the distribution amongst the states as mentioned below. (a) 10 % on the basis of income tax collection (b) Out of the remaining 90 percent, 25% on the basis of population, 25% inverse of per capita income

multiplied by population, 50% on the basis mean distance of per capita income from the highest percapita income state.

**Table 14.2**

**Finance Commissions Criteria and Weightage for Sharing Income Tax with States**

| Finance Commissions | States Share of Income Tax (%) | Criteria (weightage in %) | | |
|---|---|---|---|---|
| | | Population | Income Tax Collection | other Factors |
| I | 55 | 80 | 20 | - |
| II | 60 | 90 | 10 | - |
| III | 65 | 80 | 20 | - |
| IV | 75 | 80 | 20 | - |
| V | 75 | 90 | 10 | - |
| VI | 80 | 90 | 10 | - |
| VII | 85 | 90 | 10 | - |
| VIII | 85 | 22.5 | 10 | 67.5 |
| IX | 85 | 22.5 | 10 | 67.5 |
| X | 77.5 | 20 | - | 80 |

**Source:** Finance Commissions Govt of India

The **Ninth Finance Commission** made some minor changes to the above formula i.e.10% on the basis of income tax collection, 45% on the basis of distance of percapita of the state from the highest percapita income state, 22.5% on the basis of population, 11.25%on the basis of composite index of backwardness, 11.25% on the basis of inverse of percapita income multiplied by the population. The **Tenth Finance Commission** formula is somewhat different from the above formula i.e. 20% on the basis of population of 1971 census, 60% on the basis of distance of percapita income of state from that of the state having the highest income, 5% on the basis of area adjusted, 5 % on the basis of infrastructure, 10% on the basis of income tax collection.

**B.** **Criteria In Lieu of Sharing Excise Duty: -**There is some uncertainty in the constitution regarding excise duties, as *article 272* leaves the matter wholly to the parliament. All the finance commissions have not followed the same criterion for sharing of excise duty in India (table 13.3).The first finance commission selected three excise duties only for division among the

states and recommended distribution of 40% of its proceeds among the states. The successive finance commissions have changed the procedure of divisible pool the seventh, eighth, ninth finance commission gradually brought all the central excise duties under the divisible pool and also raised the share of states from 40 per cent to 45 per cent

**Table 14.3**

**Finance Commissions Awards (States Share, Criteria and Weightage In Lieu of Sharing Excise Duty**

| Finance Commission | States share of excise duty | On the basis of population (Weightage in %) | On the basis of backwardness, poverty etc. (Weightage in %). |
|---|---|---|---|
| I | 40% of 3 duties | 40 | 60 |
| II | 25% of 8 duties | 40 | 60 |
| III | 20% of 35 duties | 40 | 60 |
| IV | 20% 35 duties | 80 | 20 |
| V | Do | 80 | 20 |
| VI | Do | 75 | 25 |
| VII | 40% of all the duties | 25 | 75 |
| VIII | 45 % of all the duties | 25 | 75 |
| IX | Do | 25 | 75 |
| X | Do | 20 | 80 |

**Source:** Finance Commissions Govt of India

**C. Grants in Aid to States**

Indian Constitution provides for payment by the union of such sums as parliament may by law provide each year as grants-in-aid in need of assistance. Under *article 275* of the constitution, finance commission has to decide about the grants in aid to states corresponding to each five year plan, either for specific purpose such as promotion of education in a backward state or for toning up administration. Finance commissions have distributed grants by and large on the basis of budgetary needs of the states i.e. to cover non-plan gap on revenue account variously described as budgetary gap, revenue gap, financial needs etc.

**Table 14.4**

**Finance Commissions Share of Grants –In- Aid and Taxes in Total Transfers**

| Commission | Grants- in- aid | Taxes | Total |
|---|---|---|---|
| 10th | 8.96 | 91.04 | 100 |
| 11th | 13.47 | 86.53 | 100 |
| 12th | 18.87 | 81.13 | 100 |

**Source:** Finance Commissions, Govt. of India

## 14.4 THE 11th FINANCE COMMISSION (2000-2005)

In consequence of adoption of the constitution (80th) amendment in the year 2000 all the central taxes and duties (except those referred in article 268 and the surcharges and cases) are to be shared between the centre and the states.11th finance commission states share of net process of all the central taxes and duties was fixed 29.5%.The eleventh finance commission claim to have followed the two basic principles of equity and fiscal efficiency in devolving resources. The EFC gave more weightage to income distance while less weightage was given to tax effort. (Table 14.5).

**Table14.5**

**The Devolution Criteria Adopted By 11th Finance Commission**

| | **Criteria** | **Weightage (%)** |
|---|---|---|
| | Population (1971 census) | 10 |
| | Income(distance method) | 62.5 |
| | Area | 7.5 |
| | Index of infrastructure | 7.5 |
| | Tax effort | 5.0 |
| | Fiscal discipline | 7.5 |
| | Total | 100 |

**Source:** The Eleventh Finance Commission Report, Govt of India

### 14.4.1 Up gradation and Special Problem Grants:

The 11th Finance Commission provided grants for up gradation of standards in non-developmental and **social sectors and services** on the one hand and for tackling the special problems of different states on the other hand.

### 14.4.2 Calamity Relief:

All finance commissions upto 8th commission followed margin money scheme. The Ninth FC created calamity relief fund on 75:25 sharing basis among centre and states. The 10thFC recommended national fund for calamity relief (NFCR), 11th and 12thcommissions proposed national centre for calamity management by starting calamity relief fund (CRF) on sharing basis of 75:25 between centre and states.

### 14.4.3 Debt Relief:

Keeping in view the heavy debt burden on states, finance commission have been announcing debt relief for them. The 10th commission proposed a scheme of general debt relief for all states linked to fiscal performance. The 11th commission followed the same. The 12th FC estimated the debt of state domestic product ratio from 21.73% in 1997-98 to 31.15% in 2002-2003. It recommended the states to set fiscal limits similar to the ones prescribed by the FRBM act for the central government and further stated that the debt relief will be available only if states enacted the legislation for fiscal responsibility.

## 14.5 THE TWELFTH FINANCE COMMISSION (2005 to 2010).

The Twelfth Finance Commission (TFC) was appointed to cover the period from 2005 to 2010 under the chairmanship of C. Ranga Rajan

### 14.5.1 The Terms of Reference

The Commission shall make recommendations on the following matters:

(1) The distribution of net proceeds of taxes between union and states which are to be divided under chapter 1 part 12 of the constitution.

(2) The policies required to increase the consolidated fund of states on the basis of recommendation made by the finance commission of states to supplement the resources of municipalities and panchayats in the state. In making the recommendation, the commission shall have its regard, among other considerations to:

(a) The resources of the union government and state government for five years starting from 1 April 2005 on the basis of the total tax and non-tax that it will likely to receive by the end of 2003-04.

(b) The demand of the resources by the central government, in particular the need of expenditure on civil administration, internal security, defence, debt servicing and other committed expenditure and liabilities.

**Table 14.6**

**The Devolution Criteria Adopted By 12th Finance Commission.**

| | Criteria | Weightage (%) |
|---|---|---|
| | Population (1971 census) | 25 |
| | Income(distance method) | 50 |
| | Area | 10 |
| | Tax effort | 7.5 |
| | Fiscal discipline | 7.5 |
| | Total | 100 |

**Source:** The Twelfth Finance Commission Report , Govt of India

### 14.5.2 The Major Recommendations of 12th Finance Commission

The major recommendations of twelfth finance commission are mentioned as follows :

**(A) Distribution of Union Taxes**

The total share of states in the total sharable central taxes to be fixed at 30.5% and the share of states will come down to 29.5% if the states levy sales tax on sugar, textiles and tobacco. TFC gave more weightage to income distance and less weightage is given to tax effort and fiscal discipline. (Table 14.6)

**(B) Macro-Economic Stability**

The total fiscal deficit for centre and states to be reduced to 3% of GDP and the total tax-GDP ratio of both centre and states to be increased to 17.6% of GDP in 2009-10. The revenue deficit for the centre& states combined to be reduced to 0% by 2008.

**(C) Grants to Local Bodies**

The total grant that will have to give to the states for panchayati raj institutions and local urban bodies for the period of 2005-09 will be Rs 20000 crores & Rs. 5000 crores respectively.

**(D) Calamity Relief Fund**

The calamity relief fund scheme will continue as it was in the previous plans with central and states contributing in the ratio of 75: 25. The size of fund will be Rs. 21333 crore for the period of 2005-10.

**(E) Grants in Aid to States**

For the period of 2005-10, the total non-plan revenue deficit grant of Rs. 56856 crores is recommended to 15 states and the total grant of Rs. 10172 is recommended for 8 educationally backward states. A grant of Rs. 15000 crores is recommended for building roads & bridges which is in addition to the normal expenditure of the states while the grants that is recommended to the states for maintenance of public buildings, forests, heritage conversation and specific needs of states is Rs 500 crore, Rs. 100 crore, Rs. 625 crore and Rs. 7100 crore.

## 14.6 THE 13TH FINANCE COMMISSION (2010 to 2015)

The Thirteenth Finance Commission was constituted by the President under the chairmanship of Vijay Kelkar on November 13, 2007 to give recommendations on specified aspects of centre state fiscal relations during 2010-15. The commission was asked to make recommendations on the following matters:

- The distribution of taxes collected between the centre and the states.
- The principles determining the grants-in-aid to states out of the Consolidated Fund of India and the sums to be paid to states.
- The measures needed to augment the Consolidated Fund of a state to supplement the resources of Panchayats and Municipalities.
- To review the state of the finances of the centre and the states in light of the operation of the States' Debt Consolidation and Relief Facility this was introduced on the basis of the recommendations of the previous Finance Commission.
- To review the present arrangements regarding financing of disaster management.
- To suggest a new roadmap for fiscal consolidation in the period between 2010 - 2015.

### 14.6.1 Major Recommendations of 13th Finance Commission

1. The share of states in the net proceeds of the shareable central taxes should be 32%.This is 1.5% higher than the recommendation of 12th Finance Commission.
2. Revenue deficit to be progressively reduced and eliminated, followed by revenue surplus by 2013-14.
3. Fiscal deficit to be reduced to 3% of the GDP by 2014-15.
4. A target of 68% of GDP for the combined debt of center and states.
5. The Medium Term Fiscal Plan (MTFP) should be reformed and made the statement of commitment rather than a statement of intent.
6. FRBM Act need to be amended to mention the nature of shocks which shall require targets relaxation.

7. Both centre and states should conclude 'Grand Bargain' to implement the model Goods and Services Tax (GST).To incentivize the states, the commission recommended a sanction of the grant of Rs 50000 crore.

8. Initiatives to reduce the number of Central Sponsored Schemes (CSS) and to restore the predominance of formula based plan grants.

9. States need to address the problem of losses in the power sector in time bound manner.

**14.6.2 Sharing of Union Taxes**

The Commission has recommended that for its award period, the share of States in the net proceeds of union taxes may be fixed at 32%. The Commission has also recommended on the inter-se distribution of the States' share amongst the States. More weightage is given to fiscal capacity and less weightage is given to area (table 14.7)

**Table 14.7**

**The13th Finance Commission (2010-2015), Criteria (Weightage in percentage) for Tax Devolution**

| Criteria | Weights |
|---|---|
| Population(1971 census) | 25.0 |
| Area | 10.0 |
| Fiscal capacity | 47.5 |
| Fiscal discipline | 17.5 |

**Source:** The 13th Finance Commission Report Govt of India

**14.6.3 Grants -in-Aid to States**

The Commission has recommended grants-in-aid of revenues of states for non-plan revenue deficit, elementary education, environment related issues, improving outcomes, maintenance of roads and bridges, local bodies, disaster relief, GST implementation and state specific grants under Article 275 of the Constitution.

**Table 14.8**

**Thirteenth Finance Commission Grants- In- Aid to States (Rs. Crores)**

| Sr. no. | Description | (Rs. crores) |
|---|---|---|
| 1 | Local Bodies | 87519 |
| 2 | Disaster Relief (including capacity building) | 26373 |
| 3 | Post-devolution Non-plan Revenue Deficit | 51800 |
| 4 | Performance Incentive | 1500 |
| 5 | Elementary Education | 24068 |
| 6 | Environment | 15000 |
| 7 | Improving outcomes | 14446 |
| 8 | Maintenance of Roads and Bridges | 19930 |

| 9 | State-specific | 27945 |
|---|---|---|
| 10 | Implementation of model GST | 50000 |
| **Total** | | **318581** |

**Source:** Report of the Thirteenth Finance Commission, Govt. of India

#### 14.6.4 Grant for Elementary Education

The Commission has assessed the requirement of providing elementary education for each State based on the Sarva Shiksha Abhiyan norms and recommended to provide a grant of Rs. 24068 crore equivalent to 15% of the assessed requirement.

#### 14.6.5 Disaster Relief

- Assistance of Rs. 250 crore to be given to the National Disaster Response Force (NDRF) to maintain an inventory of items required for immediate relief.
- Provisions relating to the District Disaster Response Fund in the Disaster Management Act may be reviewed and setting up of these funds be left to the discretion of the individual states.
- The list of disasters to be covered under the scheme financed through FC grants should remain as it exists. However, man-made disasters of high-intensity may be considered for NDRF funding.

#### 14.6.6 Environment Related Grants

The Commission has recommended three grants under this category of Rs. 5000 crore each aggregating to Rs. 15000 crore. The first grant of each of these Rs. 5000 crore grants is *forest grant,* the second is for promotion for *renewable energy* and the third is for *water sector*

#### 14.6.7 Grants for Improving Outcomes

The Commission has recommended six grants under this category aggregating to Rs. 14446 crore over the award period. An incentive grant for reduction in infant mortality of Rs. 5000 crore is to be released to States starting 2012-13 depending on the reduction in Infant Mortality Rate (IMR) achieved by the states with reference to the baseline level of 2009-10 figures. Grant of Rs. 5000 crore for improved delivery of justice has been recommended for Lok Adalats and Legal Aid, Alternate Dispute Resolution Centres, Heritage Court Buildings, State Judicial Academy and training of judicial officers and public prosecutors. The grant for Unique Identification (UID) programme amounting to Rs. 2989.10 crore is to be released based on the number of people covered under the UID database. Two grants of Rs. 616 crore each have been recommended for district Innovation Funds and improving statistical systems at district and State levels. Finally, a grant of Rs.225 crore has been recommended for setting up database of employees and pensioners.

#### 14.6.8 Grants for Maintenance of Roads and Bridges

The Commission has assessed the requirement of ordinary repairs of roads in a State and has recommended grant of Rs. 19930 crore equivalent to 90% of the assessed requirement for PMGSY roads and 50% of the assessed requirement for other roads,

#### 14.6.9 State Specific Grants

The Commission has recommended grants aggregating to Rs. 27945 crore for various state specific needs of the States.

### 14.6.10 Goods and Services Tax (GST)

Union excise duties and sales tax are the two important indirect taxes on goods levied by the Union and the States, respectively. The tax system was characterized by cascading effects leading to distorted structure of production, consumption and exports and evasion. In this context the 13th Finance Commission has recommended a model GST structure that includes features such as single rate, zero rating of exports, inclusion of various indirect taxes at the Central and State level in GST ambit, major rationalisation of the exemption structure, etc. The Commission has recommended a grant of Rs. 50000 crore for implementation of GST as per the recommended model. This grant is to be disbursed initially in the form of compensation for loss due to implementation of GST and residual amount to be distributed amongst States in the terminal year of the award period as per the devolution formula. It has also recommended administrative structure for implementation and monitoring of this grant. The main features of the model GST are:

- The central portion of the GST would include (a) central excise duties, (b) service tax, (c) additional customs duties, (d) all surcharges and cesses.
- The state GST would include (a) VAT, (b) central sales tax, (c) cesses and surcharges, and others such as luxury tax, lottery tax, stamp duties, etc.
- There would be special provisions for certain goods such as petroleum, and exemptions would be allowed only on the basis of a common list applicable to all states and the centre.
- GST should be implemented by all states and the centre at the same time.

### 14.6.11 Revised Roadmap for Fiscal Consolidation

- The revenue deficit of the centre needs to be progressively reduced and eliminated, followed by emergence of a revenue surplus by 2014-15.
- A target of 68 per cent of GDP for the combined debt of the centre and states should be achieved by 2014-15.
- The medium term fiscal plan should be reformed and made a statement of commitment rather than a statement of intent.
- A number of disclosures including detailed break-up of grants to states, systematised statement on tax expenditure, compliance costs of major tax proposals, fiscal impact of major policy changes, should be made with the annual budget.
- The government should list all public sector enterprises that yield a lower rate of return on assets than a norm which should be decided by an expert committee.
- An independent review mechanism should be set-up by the centre to evaluate its fiscal reform process.

### 14.6.12 Fiscal Sphere of Local Bodies

Decentralisation is intended to result in greater efficiency in the delivery of Services. Local bodies being closer to people are expected to meet the local needs better than a centralized system of governance. Under Articles 243G and 243W, State legislatures may by law transfer powers and authority to rural and urban local bodies as are necessary to enable them to function as institutions of self-government. Powers and authority include transfer of functional responsibilities and powers to levy and collect taxes as may be assigned to them by the state legislatures. The responsibility for providing panchayats with an independent source of revenue as also grants for specified purposes is very much that of the state governments. The State Finance Commissions are there to ensure proper allocation of

resources as between the State and the Panchayats. If in the process of supplementation of the resources of panchayats a need arises for the augmentation of the State Consolidated Fund, it has to be considered by the Finance Commission

The 73rd and 74th Amendments of the Constitution do not provide for direct funding of local bodies by the union government. The involvement of the union government in strengthening the financial position of the local bodies is indirect following the consequential amendment made to Article 280 mandating the Central Finance Commission to make recommendations on the measures needed to augment the Consolidated Fund of a State to supplement the resources of Panchayats and Municipalities in the State on the basis of the recommendations made by the Finance Commission of the State.

In consequence of 73rd and 74th Constitutional amendments, 11th and 12th commission asked to recommended criteria for grants in aid to states local bodies as follows.

**Table 14.9**

**The Eleventh and Twelfth Finance Commissions Devolution Criteria to Supplement Resources to Local Bodies**

| Sr. No | Criteria | 11th FC Weightage (%) | 12th FC Weightage (%) |
|---|---|---|---|
| 1 | Population | 40 | 40 |
| 2 | Geographical area | 10 | 10 |
| 3 | Distance from highest percapita income state | 20 | 20 |
| 4 | Index of decentralisation | 20 | 0 |
| 5 | Index of deprivation | 0 | 10 |
| 6 | Revenue effort | 10 | 20 |

**Source:** Finance Commissions Govt of India.

## 14.7 FOURTEENTH FINANCE COMMISSION OR FFC (2012-17)

The commission was constituted on early Jan, 2013 with Mr. Y.V. Reddy, former Governor RBI, as Chairman and other as members: Prof Abhijit Sen, Mrs. Sushma Nath, Dr. M. Govinda Rao and **Dr. Sudipto Mundil.** The terms of reference of Finance Commission relates to contemporary issues important to public finance. However, the terms of reference of FFC reveal an intriguing concern—"The need for insuleting. The **pricing of public utility services** like drinking water, irrigation, power and public transport from policy fluctuations, through statutory provisions" along with restructuring of public finances, fiscal consolidation etc.

Its recommendations will now apply to state governments too, making this a move that might well hearald the transition to a more rule based regime in pricing public utility services', instead of depending on 'the whim of governments and thereby destablising public finances.'

**Major Recommendations**

The major recommendations of the FFC are mentioned below:

### 14.7.1 Sharing of Union Taxes

- To serve the twin objectives of increasing the flow of unconditional transfer to the states and get leave approprivate fiscal space to union to carry out specific purpose transfers to the states, the share of states in tax devolution (central divisible pool) to 42 pc of divisible pool. (vertical tax devolution)
- A new horizontal formula for states share in divisible pool among the state by incorporating new variables:

  (1) 2011 population and forest cover

  (2) exclusion of fiscal discipline

The finalized Cntewon and weight assigned for interse determination of shows of taxes to the states are explained in Table, as follows:

**TABLE : Table 14.10 Criteria and Weights for Determination of shares of Taxes to States**

**Table 14.10**

| S.N. | Criteria | Weight (Per Cent) Accorded | |
|---|---|---|---|
| | | 14th | 13th |
| 1. | Population (1971) | 17.5 | 25 |
| 2. | Demographic Change (2011) | 10.0 | 0 |
| 3. | Income Distance | 50.0 | 47.5 |
| 4. | Area | 15.0 | 10.0 |
| 5. | Forest Cover | 7.5 | 0 |
| 6. | Fiscal discipline | 0 | 17.5 |
| | Total | 100.0 | 100.0 |

### 14.7.2 Local Governments

The FFC recommended that local bodies should be required to spend grants only on the basic services with the functions assigned to them under relevant legislation.

Using data of population (Rural/urban) of census 2001, local governments are divided into Gram Panchayats and Municipalities:

- to empower local bodies to impose advertisement tax; to review the structure of entertainment tax; to raise the cailing of professional tax.
- Assign productive local assets to the panchayats, put in place enabling rules for collection.

### 14.7.3 Recommendations for Disaster Management

The financing of National Disaster Response Fund (NDRF) has so for been almost wholly managed through the levy of less on selected items, which will be subsumed under GST in future.

It recommended, inter alia, that all states should contribute 10 percent to state Disaster Relief Fund during the award period, remaining 90 pc coming from Union Govt.

### 14.7.4 Grants-in-Aid

- The Commission desiste from recommending specific purpose grants and have suggested a separate institutional arrangement for the purpose.

- Grants to public services of national importance i.e. health, education, drinking water and sanitation etc. (which have inter-state externalities) should be carefully asigned and implemented.

**14.7.5 Cooperative Federalism**

- Existing system of fiscal transfers from the union to states be reviewed and necessary institutional changes be considred.
- Ensure the prevailing level of transfer to states of about 4a p.c. of the gross revenue receipts.

**14.7.6 Goods and Services Tax (GST)**

- The union should bear the probable loss of states from GST introduction. GST compensation can be compensated as follows:

  100 pc. Compensation in 1st, 2nd 3rd year

  75 pc. Compensation in 4th year

  50 pc. Compensation in 5th year

- Creation of an autonomous and independent GST compensation Fund.

**14.7.7 Fiscal Consolidation Road-Map**

Recommanded set of rules as follows from the year 2016-2017 the award period:

- Ceiling for the Union Government: Fiscal Deficit of 3pc. Of GDP.
- Ceiling for the State Government: FD OF 3.5 of GSDP.
- Improving the quality of fiscal managements.
- Deplacement of FRBM Act With Debt ceiling and Fiscal Responsibiling Legislation. Invoking Article 2a in its preamble.
- States also should consider enactments under Article 293(1)

**14.7.8 Pricing of Public Utilities**

**14.7.9 - Developing** Comprehensive Public Sector Enterprise Policy with adequate forms or fiscal costs and benefits.

- Categorise PSEs in to High Priority, Priority, Low Priority and Non-Priority units.

**14.7.10 Public Expenditure Management**

- Linking outlays with outcomes; pay with productivity for future pay revisions
- States should adopt New Pension Scheme
- On 5th April 2015, The Union Govt., announced that it has released over Rs. 37,420 crores to the States as the first installment of devolution-UP got the highest followed by Madhya Pradesh. Sikkim got the least.
- Grant-in-aid of Rs. 48,906 crores for 11 revenue deficit states.
- States will have to bear expenditure on large number of centrally sponsored schemes.

Thus the FFC has made recommendation for reaching changes in tax-devolution that will move the country towards greater fiscal feudalism, confecting more fiscal autonomy to the states.

## 14.8 TRANSFER OF RESOURCES THROUGH PLANNING COMMISSION

Indian constitution entry 20 of the concurrent list *(list III)* of the seventh schedule relates to 'economic and social planning'. Planning therefore is a matter of common interest to the central and state governments. The Planning Commission was constituted in 1950 by an executive order of the Govt. of India. Planning Commission is an extra constitutional body decides grants and loans to the states for the implementation of state development plans. The Planning Commission advises the union government regarding the desirable transfer of resources to the States over and above those recommended by the Finance Commission. The transfer of resources for development purposes under the Plans came to be made under Article 282 of the Constitution. The states were highly dependent on the Union government for financing their development plans because the extra resources on which states could bank on were largely concentrated with the Union government.

Planning Commission provides for a settlement between the Centre and the states in two categories (1) Division of revenues (2) Grants in special cases. The centre adds to state resources by conferring fixed percentage of revenue from taxation and from other sources to the states. However, this does not ensure a proper balance in distribution. There are states which are poorer or more backward than the others and therefore require central finances on a much larger scale than the others. This is why recommendations for special grants were introduced. The grants were supposed to be given to the states which did not have enough capital assets that would have earned them enough money to pay for loans taken from the centre Central ministries:-non statutory discriminatory transfers made to the states by various central govt ministries in the form of centrally sponsored schemes. During the first three five year plans and three annual plans Planning Commission did not followed any clear cut criteria for allocating central assistance to states. Consequently, there were huge variations in the averages of grants and loans received by the states. A developed state which had resources got 40% as grants; an under-developed state which had no resources got 12% as grants while the average was 22%.

### 14.8.1 The Gadgil Formula

The Gadgil formula was formulated with the preparation of the fourth five-year plan for the distribution of plan transfers amongst the states. It was named after the then deputy chairman of the Planning Commission Dr. D R Gadgil. The central assistance provided for in the first three plans and annual plans of 1966-1969 lacked objectivity in its formulation and did not lead to equal and balanced growth in the states. The National Development Council (NDC) approved the following formula: Special Category states like Assam, Jammu and Kashmir and Nagaland were given preference, their needs should first be met out of the total pool of Central assistance. The remaining balance of the Central assistance should be distributed among the remaining states on the basis of the criteria given in (table 14.9).The 5$^{th}$ plan also followed the same formula which was followed during fourth plan.

### 14.8.2 The Modified and Revised Gadgil Formula

Gadgil formula was modified on the eve of the formulation of the 6$^{th}$ plan to make it more progressive for the benefit of economically backward states. The modified Gadgil formula continued for the Sixth and the Seventh Plans. Compared to the allocations in the Fourth and Fifth Plans, the

allocations during the sixth and the seventh plans show a definite shift in favour of the poorer states The tug of war among the states for central assistance still continued as each state suggested a formula which best suited its interest, this lead to revise Gadgil formula. The new revised formula is popularly known as Gadgil-Mukherjee formula after the name of then deputy chairman of Planning commission Dr. Pranab Mukherjee. The plan assistance takes the form of 70% loans and 30% grants for general category of states, while it is composed of 10% loans and 90% grants for the special category of states.

**Table 14.11**

**Original, Modified and Revised Gadgil Formula for Central Plan Assistance to States (Weight %)**

| Serial No. | Criteria | Original Formula 4th & 5th Plans | Modified Formula 6th & 7th Plans | Revised Formula (Gadgil-Mukherjee Formula) 8th Plan on Wards |
|---|---|---|---|---|
| 1 | Population | 60 | 60 | 55 |
| 2 | Per capita income below the national average | 10 | 20 | 25 |
| 3 | Per capita tax effort | 10 | 10 | _ |
| 4 | Out lay on continuing irrigation and power projects | 10 | _ | _ |
| 5 | Performance | _ | _ | |
| 6 | Special problems | 10 | | 15 |
| 7 | Fiscal management | - | - | 5 |
| | **Total** | **100** | **100** | **100** |

**Source:** Finance Commissions Govt. of India

Under the new revised formula, population was given maximum weightage by considering it as most important factor for the allocation of central assistance, but in comparison with old Gadgil formula the weightage has been reduced by 5%.The share of Per Capita Income has increased from 20% to 25%. Fiscal management, as a new criterion has been introduced with 5% weightage by discarding the earlier tax effort criterion which was given 10% weightage in old Gadgil formula. Fiscal management criterion is to be assessed on the basis of a state's actual resource mobilization for its plan in comparison with the target agreed upon the Planning Commission. Therefore this criterion is considered to be more comprehensive for fiscal efficiency than the tax effort criterion.

The fiscal management was given only 5% weightage due to the danger arises from the manner in which it is defined. It can develop an unhealthy competition among the states to show their resources less at the time of preparing initial resource estimates.The remaining 5% weightage of tax effort has been given to the special problems criterion dueto which its weightage increased from 10% to 15%. The NDC has defined special problems under these seven heads:

1. Coastal areas

2. Flood and drought prone areas
3. Desert problems
4. Special environmental issues
5. Exceptionally sparse and densely populated areas
6. Problem of slums in urban areas

The Government of India, in keeping with its reform agenda, constituted the NITI Aayog to replace the Planning Commission instituted in 1950. This was done in order to better serve the needs and aspirations of the people of India. An important evolutionary change from the past, NITI Aayog acts as the quintessential platform of the Government of India since 2015 to bring States to act together in national interest, and thereby fosters Cooperative Federalism.

### 14.8.3 Resources transfer through centrally sponsored schemes

A part from direct transfers, resources also flow to the states indirectly through (a) establishment/ expansion of central public sector enterprises (b) subsidised lending by banking and other financial institutions and (c) subsidised borrowing by the states from central govt. Keeping in view of the national importance some of the schemes are launched by the centre and implemented by the states government with central assistance by the central ministries, and formula approved by Planning Commission. But states are unhappy with their inadequate involvement in the formulation, matching grants favours the richer states because they are better placed to provide matching to avail central assistance.

**Self Assessment Question**

Q. 1 Mention major recommendations (any two) of the Fourteenth Finance Commission of India.

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## 14.9 REASONS OF CONFLICT BETWEEN CENTRE AND STATES' FINANCIAL RELATIONS

Currently a lot of controversy is going on regarding central and state financial relations in the country. States argues that centre has not paid attention to their needs, resulted financial imprudence, whereas central govt. feels that states are over depending on transfer of resources instead of mobilisation of resources at their own level. The reasons for conflict are.

- **Over lapping of functions:-** Revenue gap grant is to be made by the finance commission, plan assistance by Planning Commission and relief grants by the central government. But in practice one is encroached in the area of the other.
- **Arbitrariness in resources transfer:-** In practice resources transfer depends on what government at centre considered as justified, it depends on Political understanding between the centre and the individual state.

  States feeling of negligence because of disequilibrium between functions and resources. Weightage to economic backwardness:-since 6$^{th}$ Finance Commission only, the weightage

given but it is inadequate.

- **Increasing dependence on centre:-** Tax resources assigned to states are less elastic, and duties and responsibilities are increasing at fast rate so that states have become more and more dependent on the centre financially.
- **Eroded state autonomy:-** The framers of our constitution were guided by the notion of strong centre and weak states. The interference of the centre in the functioning of state government has been encouraged by the concurrent list.
- **Improper division of responsibility:-** The division of responsibility between the Planning Commission and the Finance Commission was not based on proper guidelines i.e. promising tax effort and showing revenue gap. Some states managed larger assistance from both the planning and finance commission.
- **Lack of consistency in devolution:-**There are no uniform and mutually acceptable and unanimous scientific criteria. There is un-certainty to forecasted grants and no confidence; hence states are not in a position to plan their programmes with optimism.
- **Improper estimation of resources gap:-** With regard to grants in aid recommended by finance commission to help the states to reduce budgetary deficit, the major difficulty relates to scrutiny of budgets of the states. These require the proper reading of the tax effort and economy in-expenditure. But it is difficult to determine. In most cases states shown larger deficit by over estimating expenditure to reap larger grants.
- **Reduced importance to Finance Commission:-** The major part of revenue gap of states has been covered by the plan grants and loans to states, moreover discretionary, relief grants are made by ministries and /planning commission are not based on an effective objective criteria.
- **Failure to reduce regional imbalance:- Horizontal imbalance** among the states and the disparity in percapita income had been on the increase. Sometimes richer states procured larger grants and loans, compared to weaker states, which further increased disparities. Many advanced states, by showing more deficit, got discretionary grants and some got on the basis of political considerations.
- **Growing inter-state inequalities:-** The growing regional imbalances both inter-State and intra-state are matters of serious concern and are counter to the objective of realising the goal of inclusive growth. Disparities among states have been steadily increasing particularly since the initiation of economic reforms in the country. The Eleventh Five-Year plan document expressed concern over the widening income differentials between more developed and relatively poorer States. In the post-reform period, private investment had gone mostly to southern and western States because of proximity to ports, better infrastructure and perceptions regarding better governance
- Devolutions on the basis of past time performance
- One of the criticisms against the working of the Finance Commissions is that the Transfers and more particularly the inter se distribution of tax devolution recommended by them are based on past indicators and not on forward indicators. Union Government obtains external assistance on concessional terms, but the benefit of the same is not correspondingly passed on to the states
- **Persistent large overdrafts** reflect a fundamental disequilibrium in states finances. Further, large overdrafts result from situations beyond their control, including delays in releasing of central transfers and genuine unforeseen expenditures, while the union government has an easy and regular access to deficit financing,
- Some State Governments are of the view that the recommendations of the Finance Commission

should be implemented *in toto.* The **non-implementation of the final recommendations in full** will add another dimension to the problems in financial relations between the Union and the States.

- States have **not sufficiently made use of the taxation powers allotted to them.** In particular, the example of not levying or withdrawing the levy of Agricultural Income Tax. After Green Revolution the expansion of irrigation facility, hybrid seeds, chemical fertilisers and research in soil fertility, a very large number of agriculturalists have come to occupy the upper bracket of elite group in the society.
- **Inadequacy of resources at the disposal of the states,** along with other factors can be due to lack of fiscal discipline. The centre had not taken sufficient measures to impose all the taxes under *Article 269* whose proceeds would go to the states. Surcharge on income tax were imposed by the central government but the proceeds were not shared with the states. Lose accrue to state governments are more than the compensation which will be provided by the central government for implementing Goods and Services Tax (GST).

## 14.10 SUGGESTIONS FOR THE IMPROVEMENT IN THE CENTRE-STATE FINANCIAL RELATIONS

For the proper functioning of the federal setup, national integration, harmonious balanced development and to improve political and economic ties between central and state governments thinkers, committees like Rajmannar Committee, Sarkaria Committee, Finance Commissions, Ram Murthy Committee, National Development Council, and parliamentary committees and states made number of suggestions ; among those few suggestions are given as follows .

- **Greater autonomy to states**:-states be allowed to function without interference from the centre, at least in the areas originally specified by the constitution. Because of the increasing state activities, functional powers of the states also need to be enlarged and larger financial autonomy granted to them.
- **Removal of overlapping of functions between finance and Planning Commissions:-** A clear out jurisdiction of powers for these two bodies should be drawn, government and the Planning Commission before making any plan grant should verify that the finance commission has not sanctioned any grant for the same purpose.
- **Reduction of financial dependence:-** To implement planned programmes, more taxes should be brought to the divisible pool and larger slice of share allowed to the states, to implement their planned programmes without facing resources crunch.
- **Ensuring proper use of conditional grant**:- conditional grants for specific purposes like plan schemes or relief works which are sanctioned by the planning commission or ministries, are often diverted to other purposes by states, so this type of diversion is to be checked so proper vigilance needed.
- **More effective use of loans and un-conditional grants**:- Loans should use productively and efficiently. The responsibility of recommending unconditional grants should be entrusted to a quasi-judicial body and the finance commission must avoid political pressure and consequent criticism.
- **Scope of Finance Commission should be widened**:- If the scope of finance commission is widened the Planning Commission will not have reasons to feel its power shared nor will the government have scope for arbitrary deal with resource transfer. Since finance commission is a quasi-judicial body, its widened scope will also help reducing suspicion and distrust of the states.

- **Reconstitution of National Developmental Council:-** NDC is consulted in the finalisation stage of plans so it remained as an informal get together Sarkaria Commission named it as National Economic and Development Council (NEDC), should be involved in the formulation of the plans right from the beginning.
- **Permanent status to Finance Commission**:- This will reduce the arbitrariness of centre relating to discretionary transfer of funds to states. FC should free from any political biasness and pressure. An expert non-political agency should be established as a watch dog and collect vital information relating to implementation of Commission awards.
- **Enlargement of divisible pool**: - Divisible pool should be enlarged so that the states get larger resources through tax sharing and statutory grants rather than through discretionary loans and grants.
- There should be much better **coordination between the Finance Commission and the Planning Commission.** The synchronization of the periods covered by the Finance Commission and the five-year plan will considerably improve such coordination.
- **States need to make greater efforts to increase resources within their existing powers** before seeking more powers or large central assistance. The potential tax base available for the States is quite large and relatively more elastic. If effectively managed, the tax-base of the States can yield much larger revenues.
- **Surcharge on income tax** would have been sharable with the states. Improvement in the return on investment and enterprise secured by the states would make a sizeable contribution to reducing the gap between their revenue expenditure and own tax and non-tax revenues". Enlarge the 'own' resources of the States by transferring more powers of taxation to them and the size of the sharable pool be increased. Financial resources, other than tax-revenues of the union, be also distributed between the centre and the states
- In order to overcome the resistance by interested groups and in the interest of uniformity in taxation, the **union may levy a tax on agricultural income and** its net proceeds be assigned to the states. A well balanced distribution of heads of taxation based on economic and administrative rationale between the union and the states and adequate arrangements for sharing of resources is vital for the proper functioning of the two-tier polity.
- The **terms of reference of the Finance Commission should be broader** and comprise of matters which would take care, in a comprehensive way of aspects of the financial relations between the Union and the States. Planning Commission and National Development Council for playing crucial role in planning and co-ordination, hence both the bodies should be specifically mentioned in the constitution.
- The efforts have not succeeded **in tapping the full potential of the service sector of** a vast range of services which are primarily local in nature. It is necessary to enhance the revenue potential of the States in view of their major responsibilities for social and physical infrastructure. It might be worthwhile to provide explicitly for taxing power for the States in respect of certain specified services.
- Central Govt should exercise **economy in its expenditure**, by doing so it will command more resources for distribution among the states. There should be an atmosphere of mutual good will and trust between central and state governments. As per states demand that the 75 percent of the central revenue should be automatically transferred to the states and Finance Commission should have power to recommend objective criteria for devolution of resources.

Final solution to the problem does not lie in changing the constitutional provisions but essentially lies in maintaining objectivity in implementing the existing provisions.

**Self Assessment Question**

Q. 2 Mention 4 major conflicts between Central and State Government of India.

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## 14.11 Multi-unit Finance

India is a federal country. Federal system of the nation derives its existence from its Constitution. And in such a system, powers are divided between Union and State governments. The federal structure adopted in India has made a clear cut distinction between the union and state functions and also sources of revenue as we have already studied. Imbalance arises between functional responsibilities and financial resource, calling for transfer of resources from the centre to the states to correct both vertical and horizontal imbalances.

There are three mechanisms i.e. Finance Commission, Planning Commission and interministerial sponsored schemes for devolution of resources. Finance Commission has made a significant contribution towards correcting, to some extent the disequilibrium of resources not only as between the union and the states but also between the states interse. Planning commission decides grants and loans to the states for the implementation of state development plans. List 1 contains 12 items of tax. Though they are all in the Union List, it does not mean that the revenues fiom all these items accrue to the Union Government, These 12 items fall under four categories. They are as follows: The taxes levied, collected and retained by the Union e.g. Customs and Corporation taxes. Taxes levied and collected by the Union, but. assigned wholly to states. All the taxes under Article 269" come under this category. Taxes levied and collected by the Union but shared with States. For eg., Income tax under Article 27018 and Union Excise duties under Article 272 Taxes levied by the Union but collected and appropriated by the States. The Items in the Article 268 are covered under this category, In the case of shared taxes Article 270 provides for the obligatory sharing of income tax and Article 272 provides for permissive sharing of Union Excise duties. As regard to the State List, there are 19 tax items as against 12 items in the Union List of which the State has overall powers enumerated in the list. The most important tax sources in the State List are land revenue, agricultural income tax, sales tax etc. There is no complication about States' taxes, unlike the Union taxes. This would enable the states to be financially independent. In India there is no overlapping tax jurisdiction. It is clear fiom the division of resources between both layers of Govemment i.e., the central and the State Government, A comprehensive enumeration of taxes has been made and each is under the legislative jurisdiction of either layer of the Government and the residuary powers if any rest with the Union Government. Taxes that have an inter-state base were under the legislative jurisdiction of the Union while the taxes of a local base are under the legislative jurisdiction of the State Governments. The union government has the power to levy all taxes which the past experiences in other countries has revealed to be inexpedient to leave to the regional governments. Progressive heavy all-India taxes like general income tax company taxation, capital taxation, wealth and expenditure taxes, customs duties, excises, terminal taxes on goods or passenger by sea air and rail taxes on railway fares and freights, taxes on transaction in stock exchanges, taxes on goods in the course of inter-state trade or commerce, etc.

belong to the union. The states on the other hand have with them land revenue, agricultural income tax, estate and succession duties on agricultural property, taxes on land and buildings, restrictive excises, sales and purchase taxes, electricity and entertainment duties, taxes on advertisement, vehicle taxes, taxes on professions, trade and callings etc

The Indian Constitution attempts to divide the sources of revenue on the principles of efficiency and adequacy to avoid double taxation and duplication of the tax machinery which is common in other federations. The interests of the States are further safeguarded by Article 274 of the constitution by introducing 'Surcharge' on the Union taxation for the purpose of the States' source of revenue. Generally, a certain percentage was imposed on the Union taxes as a surcharge for the States' purposes.

Currently a lot of controversy is going on regarding central and state financial relations in the country. States argue that centre has not paid attention to their needs, resulted financial imprudence, whereas central govt. feels that states are over depending on transfer of resources instead of mobilisation of resources at their own level.

Federalism is a compromise between national unity and regional interest, and this compromise should properly maintained. Central government cannot function on the usual assumption of very strong centre and highly dependent states. States may not be so correct in demanding complete financial autonomy and independence. Final solution to the problem does not lie so much in changing the constitutional provisions but lies in maintaining objectivity in implementing the existing provisions by maintaining an atmosphere of mutual good will and trust between central and state governments.

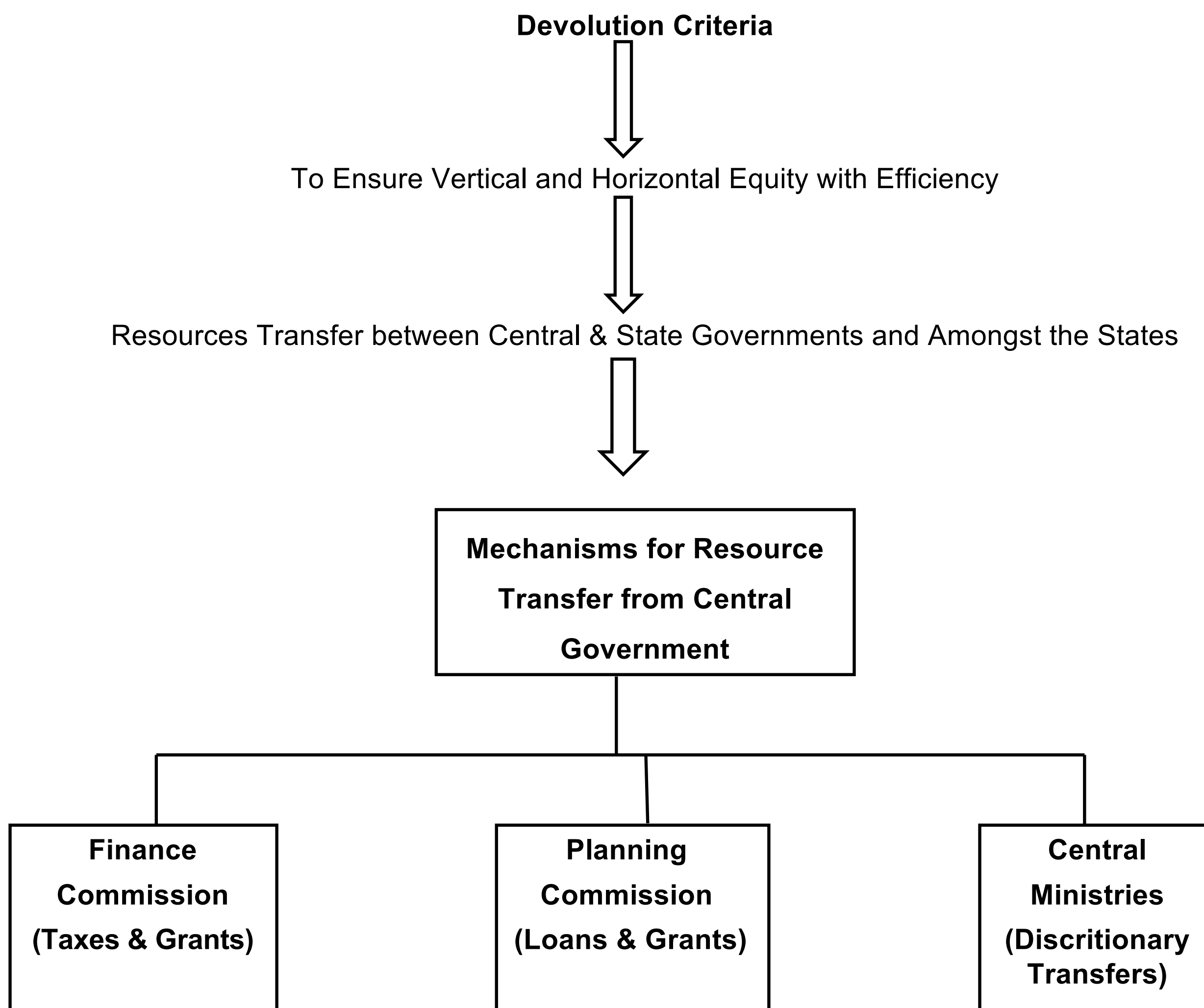
Prof. Seligman prescribed three principles on the basis of which revenue sources i.e., taxes should be divided between the different layers of government.These fundamental principles governing resource allocation are:a) Efficiency,(b) Suitability, and(c) Adequacy.

Efficiency norms insist that tax allocation among different layers of government should be decided by the capacity of feasibility to administer the tax effectively. There will be taxes, which can be best administered by the centre. Such taxes should be assigned to the central government. For example income tax in India .Likewise some taxes which can be administered by the state government, such taxes should be assigned to the state government. Best example is agricultural income tax. There is clear division of taxes among centre, states and local governments- union list, state list and concurrent list. Taxes will possess wider or narrow jurisdiction. Taxes with narrow jurisdiction should be allocated to regional or local governments rather than central government. The adequacy norms insist that revenue assigned to a particular layer of government should be sufficient to carry out the functions and responsibilities assigned to them.The non-coordination between functions of government and revenue allocated to discharge the functions generate crucial problem in federal finance. Prof. Seligman in his Essays in Taxation observes” no matter how well intentioned a scheme may be or how completely it may harmonies with the abstract principles of Justice, if the tax does not work administratively, it is doomed to failure”.

Therefore as a matter of fact there are no uniform principles which determine the resource allocation in federal finance.

Prof. B.P Adarkar in his master piece “Principles and Problems of Federal Finance.” laid down three principles governing the working of Federal Finance. Later economists added a few more principles based on certain practical situations.

## 14.12 SUMMARY




## 14.13 GLOSSARY

- **Finance Commission:** It is constitutional semi judicial body entrusted with this responsibilities – (a) allocating central revenues between Centre and States of India; and (b) to address horizontal and vertical imbalances.
- **Planning Commission:** It was an extra constitutional body (now replaced by NITI Ayog) to decide grants and loans to states for the implantation can of State Plans. It also used to advise transfer of resources for development purposes under the plans.

- **Vertical Imbalance:** It refers to revenue resource division between Centre and State.
- **Horizontal Imbalance:** It refers to differences in income, resource mobilisation and provision of public goods across states.

  These imbalances may be (a) vertical and (b) horizontal federal fiscal imbalances. Vertical Federal fiscal imbalance is the non-correspondence between the expenditure requirements of the functionary and the extent of Revenue raised from the sources assigned to the Unit as compared to the national government in a federal system. Horizontal federal fiscal imbalance is the imbalance between the expenditure requirements and own revenues of different constituent units of a federation mainly on account of difference in fiscal capacities.Due to difference in resource endowment, level of development and variation in the implementation of tax expenditure programmes among different states in a federation, the central and state taxes generate unequal fiscal residue for their citizens. Thus a gap in fiscal residue arises and the some must be equalized to achieve, what is called horizontal fiscal balance

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## 14.15 FURTHER READINGS


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- Choudhry. R.K (2009) *Public Finance an0d Fiscal Policy*, Kalyani Publications, Ludhiana.
- Datt and Sundaram (2012) *Indian Economy*, S.Chand & Company Ltd., New Delhi.


## 14.16 MODEL QUESTIONS

(1) What are the reasons for conflict between central and state governments in sharing financial resources and suggest measures for improvement?

(2) Critically examine the central and state financial relations in India?

(Hint: Devolution criteria of all Finance Commissions and Planning Commissions)

(3) Evaluate the devolution criteria followed by 13$^{th}$ and 14$^{th}$ Finance Commissions in India?

(4) What are the mechanisms available for devolution of financial resources in India?

(Hint: Finance Commissions, Planning Commission and central ministries)

(5) Critically examine the devolution criteria being followed in India?

(Hint: Devolution criteria of recent three Finance commissions and Planning Commissions)

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**Sample Question Paper**

**M.A. 2nd Semester**

**2042**

**ECONOMICS (In all Mediums)**

**Paper: 204: Economics of Public Finance**

**Time Allowed: Three Hours** **Maximum Marks: 80**

**Note :-** Attempt five questions in all including Q. No. I which is compulsory and selecting one from each Unit.

I. Write short notes on any **ten** of the following:

(i) Define Public Finance.

(ii) Private Goods.

(iii) Public Budget.

(iv) Tax Incidence.

(v) Direct Taxes.

(vi) Burden Of Taxation.

(vii) Ability to Pay Principle.

(viii) Public Expenditure.

(ix) Non-planned Expenditure.

(x) Development Expenditure.

(xi) Deficit Finance.

(xii) Public Debt.

(xiii) Public Debt Management

(xiv) External Debt.

(xv) Debt Trap. 10x2=20

## UNIT-I

II. Explain the difference between Private and Public goods. Explain the efficient provision of public goods in General Equilibrium Approach. 15

III. Explain the role of Public budget in allocation and distribution of income. 15

## UNIT-II

IV. Explain the ability to pay principle of taxation. 15

V. Explain the effects of taxation on work-effort and savings. 15

## UNIT-III

VI. Explain the Wagner's Law of increasing state activities. To what extent this theory is relevant today? Discuss. 15

VII. Explain the causes of increase in Public Expenditure in India. Explain the major recommendations of Expenditure Reforms Commission. 15

## UNIT-IV

VIII. Analyse the role of deficit financing in Public budget. Does deficit financing always lead to inflation? Discuss. 15

IX. Explain debt burden. Explain the principles of Debt Management. 15