UNIT 11 TAXATION AND EXPENDITURE IN INDIA

Structure

11.0 Objectives

11.1 Introduction

11.2 Role of Fiscal System in Economic Development

- 11.2.1 Objectives of Budgetary Policy
- 11.2.2 Limitations of Budgetary Policy

11.3 Union Finances

- 11.3.1 Components of Union Budget
- 11.3.2 Concept of Deficit
- 11.3.3 Trends in Union Budget

11.4 State Finances

- 11.4.1 Results of Reform Measures

11.5 Local Finance

- 11.5.1 State of Finances

11.6 India's Tax Structure

- 11.6.1 Main Aspects of India's Tax Structure
- 11.6.2 Evaluation of the Tax System

11.7 Growth of Public Expenditure in India

- 11.7.1 Size of Public Expenditure
- 11.7.2 Classification of Public Expenditure
- 11.7.3 Causes of Growth in Public Expenditure
- 11.7.4 Need to Cut Public Expenditure

11.8 Public Debt in India

- 11.8.1 Growth of Public Debt
- 11.8.2 Problems of Public Debt
- 11.8.3 Evaluation of Debt Policy

11.9 Let Us Sum Up

11.10 Key Words

11.11 Some Useful Books

11.12 Answers or Hints to Check Your Progress Exercises

11.0 OBJECTIVES

After reading this unit, you will be able to:

- explain the role of fiscal system in the process of economic development vis-a-vis the objectives and limitations of budgetary policy;
- identify the different concepts of budgetary deficit and its importance;
- discuss the trends in union revenue and expenditure over the period of 1950s to 2008;
- explain the situation in regard to state and local finances;
- bring out the basic features of Indian tax structure making an evaluation of the same;
- outline the causes for rapid growth in public expenditure in India; and
- discuss the problems associated with public debt and the related policy framework.

11.1 INTRODUCTION

As reviewed in the preceding unit (unit-10), in the federal system of finance that obtains in India, three tiers of government operate with independent areas of responsibility and sources of revenue. These three tiers are (i) the Union government, (ii) the State government, and (iii) the Local government. In this unit, we first review the state of finances of each of these tiers of government. We then analyse the trends in their aggregate tax revenue and expenditure patterns. We finally make an evaluation of the trends of public debt and discuss the associated policy issues.

11.2 ROLE OF FISCAL SYSTEM IN ECONOMIC DEVELOPMENT

The essence of a fiscal system is contained in the management of finances of the State. This includes: (i) assessment of the requirements of the State's finances, (ii) modalities of raising revenue and (iii) supervision & control over the allocation of revenue and its efficient expenditure to realise the objectives of the State. Two major features of the fiscal system are therefore of: (a) raising revenue, and (b) incurring of expenditure by the government. The statements relating to these two are integrated in a document popularly known as the **budget**. A budget (whether of union or state or any other tier of government), shows the relationship between the estimated financial receipt (and actual receipt

for the previous year) and its disbursement (and actual expenditure for the previous year). The relationship is shown separately for the various departments/programmes/schemes of a government. A budget is therefore regarded as an important instrument of economic planning and policy.

11.2.1 Objectives of Budgetary Policy

In a developing economy, the budgetary policy (i.e. fiscal policy) has to perform an important role. Broadly, they are expected to achieve the following objectives:

i) promote the growth of the economy by making productive investment both in the public and the private sectors;

ii) mobilise maximum resources for investment keeping in view of the returns on those investments so as to ensure the growth of marginal and average rates of savings in the economy;

iii) promote a measure of economic stability needed to realise the maximum growth of the economy; and

iv) redistribute the national output to ensure balanced regional development.

11.2.1 Limitations of Budgetary Policy

A number of factors can be identified which limit the effectiveness of realising the budgetary policy objectives in a developing economy. Among these, the more important are:

a) the rigidity and narrowness of the base of the tax structure posing difficulties for the establishment of a well-knit and integrated tax policy framework;

b) the lack of a sound and reliable data base on income, expenditure, savings, investment, employment, etc. making it difficult for public authorities to formulate a rational and effective budgetary policy; and

c) a lack of administrative machinery required to collect the revenue and ensure its effective spending.

11.3 UNION FINANCES

In making an analysis of the finances of the Government, the annual budgets provide the required basis. In this section, we take a brief look at: (i) the components; (ii) the concepts of deficit in budgets; and (iii) the trends in the Union Budgets of India.

11.3.1 Components of Union Budget

The budget of the Central or Union Government is divided into two parts: (i) revenue budget (or account), and (ii) capital budget (account).

Revenue budget covers those items which are of a recurring nature.

Capital budget covers those items which are concerned with acquiring and disposal of capital assets. Each account has a receipts side and an expenditure side. **Receipts in** the revenue budget consist of those items that carry no repayment liability (e.g. tax revenue, revenue surpluses etc.). Receipts in the capital budget consist largely of internal and external borrowings net of repayment; they also include recovery of loans and advances and some other receipts such as by sale of assets.

On the expenditure side, revenue expenditure is divided into two categories: development expenditure (or plan expenditure) and non-development expenditure (or non-plan expenditure). Development expenditure consists of expenditure on social and community services such as education and health, and on economic services, such as agriculture, industry, power, transportation and communication. Non-development expenditure consists of expenditure on administration and defence, and also payment of interest on public debt. Broadly speaking, revenue expenditure is expenditure on maintenance of existing levels of services. Capital expenditure, on the other hand, is concerned with acquiring of capital assets i.e. for the expansion of the level of services. Ideal fiscal management requires that revenue surplus should be available to finance capital expenditure.

11.3.2 Concept of Deficit

There are three type of deficits in any budget viz. (i) Revenue deficit, (ii) Budgetary deficit, and (iii) Fiscal deficit.

Revenue deficit is the difference between the revenue receipts and the revenue expenditure.

Budgetary deficit is = (Revenue receipts + Capital receipts) - (Non-Plan expenditure + Plan expenditure).

Fiscal deficit = (Revenue receipts + Non-debt capital receipts) - Total expenditure (i.e. total of plan and non-plan expenditure). It indicates the total borrowing requirements of Government from other sources to meet the total estimated expenditures of the government.

Fiscal deficit is further split (or decomposed) into primary deficit and interest payments by Government. Primary deficit is also further split into revenue deficit and capital deficit. Primary deficit on revenue account would therefore equal revenue deficit less interest payments. Primary deficit on capital account would correspondingly equal capital expenditure less loan repayments.

These relationships can be brought out clearly with the help of the following data (Table 11.1) relating to the union budget for 2006-07 and 2008-09.

Table 11.1: Union Budget Data- 2006-07 & 2008-09

(Rs. Crores)

	2006-07	2008-09
1. Revenue Receipts	434,387	602,935
2. Tax Revenue	351,182	507,150
3. Non tax Revenue	83,205	95,785
4. Capital Receipts (5+6+7)	149,000	147,949
5. Recovery of Loans	5,893	4,497
6. Other Receipts	534	10,165
7. Borrowing & Other Liabilities	142,573	133,287
8. Total Receipts (1+4)	583,387	750,884
9. Non-Plan Expenditure	414,527	507,498
10. On Revenue Account of which	373,991	448,352
11. Interest Payments	150,272	190,807
12. On Capital Account	41,336	59,146
13. Plan Expenditure (14+15)	169,860	243,386
14. On Revenue Account	142,418	209,767
15. On Capital Account	27,442	33,619
16. Total Expenditure (9+13)	584,387	750,884
17. Revenue Expenditure (10+14)	516,409	658,119
18. Capital Expenditure (12+15)	68,778	92,765
19. Revenue Deficit (17-1)	82,022	55,184
20. Fiscal Deficit {16– (1+5+6)}	143,573	133,287
21. Primary Deficit (20-11)	-6,699	-57,520

Conventionally, government deficits have been measured in terms of budgetary deficits. But in recent times, the focus has shifted to fiscal deficits. The shift of focus to the fiscal deficit internationally is mainly due to the shift in emphasis on macroeconomic principles of fiscal management.

11.3.3 Trends in Union Budget

The trends in Union Budget for the period 1956 to 2008 are presented in Table 11.2. Measures of revenue and fiscal deficit expressed as

Table 11.2 : Overall Budgetary Position

(Rs. Crores)

	Deficit (-) or Surplus (+) under Revenue Account	Deficit (-) or Surplus (+) under Capital Account	Total Budgetary Deficit
II Plan (1956-61)	+220	-1,156	-936
III Plan (1961-66)	+1,018	-1,791	-773
Annual Plans (1966-69)	+413	-1,177	-764
IV Plan (1969-94)	+411	-2,433	-2022
V Plan (1974-79)	+2,672	-6,328	-3656
VI Plan (1980-85)	-9,158	-1,629	-10,787
VII Plan (1985-90)	-46,905	+9,557	-37,348
VIII Plan (1992-97)	-1,45,875	+1,07,680	-38,195
IX Plan (1997-02)	-3,87,704	+3,87,704	-
X Plan (2002-07)	-4,79,354	+4,79,354	-
2007-08	-63,488	+63,488	-
2008-09	-55,184	+55,184	-

Source: Union Budgets

percentage of GDP at current market prices for the period 1991-2008 are presented in Table 11.3. The broad trends flowing from the data therein are as follows:

1. Till the end of the 1970s (or the end of V plan period), the Union Government used to have larger surpluses under the revenue account (Table 11.1). In other words, the centre was reasonably successful in keeping the revenue expenditure under check, record a surplus in revenue account and use that surplus to support capital budget. The reversal of the trend since the early 1980s suggests that the centre has been unable to control the steep increase in conventional expenditure or a diversion of funds (i.e. non-developmental expenditure), which could have financed the creation of tangible assets via developmental expenditure.

2. Well till mid-1990s, the Government used to have a deficit on the capital account. But, since the mid-1980s, surpluses have appeared on the capital account (Table 11.2). The share of capital expenditure in the total expenditure has, however, declined from 37 percent during 1980-85 to 12.35 percent in 2008-09. This is due to declining revenue surpluses which has consistently decreased right through the VI Plan Period (1980-85 : Rs.- 9158 crores) to the X Plan Period (2202-07 : Rs. - 4,79,354 crores).

3. Revenue deficit as a proportion of fiscal deficit stood at 41.7% in 1990-91 (Table 11.3). It rose to 79.7 percent in 2003-04. Subsequently, this proportion came down to 62.4 percent in 2004-05 and continued to decline to reach the level of 44.3 percent in 2008-09. Thus, the fiscal deficits which were driven by large revenue deficits is showing an improvement with the continued decline of revenue deficit as a proportion of GDP since 2003-04.

Table 11.3: Measures of Deficit of the Central Government

(as percentage of GDP at current market prices)

Year	Revenue Deficit	Gross Fiscal Deficit	Cot. 2 as a% of Col.3
1	2	3	4
1990-91	3.47	8.33	41.7
1991-92	2.64	5.89	44.8
1992-93	2.63	5.69	46.2
1993-94	3.81	7.01	54.4
1994-95	3.07	5.71	53.8
1995-96	2.52	5.10	49.4
1996-97	2.40	4.90	49.0
1997-98	3.04	5.82	52.2
1998-99	3.82	6.47	59.0
1999-2000	3.46	5.36	64.6
2000-01	4.05	5.65	71.7
2001-02	4.40	6.19	71.1
2002-03	4.40	5.91	74.5
2003-04	3.57	4.48	79.7
2004-05	2.49	3.99	62.4
2005-06	2.58	4.09	63.1
2006-07	1.94	3.50	55.4
2007-08	1.52	3.30	46.1
2008-09	1.35	3.05	44.3

Source: Union Budgets

The above trends indicate a violation of the principles of sound public finance that ‘consumption must be financed by current income’. Consumption financed through borrowing, while only postponing the inevitable adjustment, makes such consumption unsustainable in the long term.

Risks of High Fiscal Deficit: There are several risks with high fiscal deficits. These are:

a) Fiscal deficits, spilled over, could lead to macroeconomic instability particularly if the government resorts to deficit financing (i.e. borrowing beyond a limit and printing of new currency);

b) High fiscal deficits imperil national saving rates, thereby reducing overall aggregate investment. This further jeopardises the sustainability of high growth. Low levels of public investment renders poor physical infrastructure incompatible with large increases in national domestic product. Thus, without an increase in the scale and rate of growth of infrastructure investment, economic growth rates remain moderate as has been the experience with India;

c) The continuing large fiscal deficits, even if they do not spill over, lead to macro-economic instability in the short run requiring higher taxes to cover the burden of internal debt. High tax rates will place the country at a significant disadvantage relative to other fast-growing countries by reducing the competitive strength of the domestic producers;

d) Larger fiscal deficits have adverse effects on balance of payment (BoP) too. Aggregate excess demand representing a shortage of domestic supplies spills over as current account deficit (CAD). External loans raised to finance the CAD, ultimately leads to a BoP crisis; and

e) With large fiscal deficits, even an independent monetary management cannot sustain a low interest rate regime. This, therefore, impinges on a necessary condition for macroeconomic stability that 'real interest rate must be lower than the GDP growth rate'.

There is therefore an international consensus that the fiscal adjustment is the first and foremost task. How to achieve this is an aspect covered in the next unit (Unit 12) under the theme of 'fiscal reforms'.

Check Your Progress 1

1. Outline in brief the objectives of budgetary policy in a developing economy like India.

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2. What are the major components of Union Budget In India?

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3. Differentiate between different measures of deficit.

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4. Explain in brief the principal budgetary trends in India.

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11.4 STATE FINANCES

Like in the Union budgets, there has been a growing volume of revenue deficits in the State finances too. In response, the union and the state governments have together formulated a strategy to address the fiscal problems confronting the states. This strategy has taken the form of a package of ***'advance financial assistance'*** which is provided by the centre along with an appropriate time-bound programme of a ***'medium-term fiscal reform'*** to be undertaken by the concerned state. The time-bound programmes comprise specific measures aimed at promoting the following:

i) Reduction in non-plan revenue expenditure through appropriate measures by downsizing the staff strength of the government wherever possible;

ii) Introduce Pricing/subsidy reforms to reduce the fiscal burden of the state on the one hand and improving the allocative efficiency on the other;

iii) Introduce institutional reforms to improve the efficiency in the delivery of public services;

iv) Reduction in the role of Government from non-essential areas through decentralisation, disinvestment and privatisation;

v) An Incentive Fund to be created for incentivising the implementation of fiscal reforms in states;

vi) A model fiscal responsibility legislation at the state level was formulated which has since been implemented by most of the states. The model provides a broad framework leaving it to the discretion of the states to work out the specifics; and

vii) A debt swap scheme was introduced to enable the states to prepay high cost debt by introducing current small savings and open market loan initiatives.

11.4.1 Results of Reform Measures

There has been a dramatic turn-around in the state finances following the implementation of the reforms measure. The gross fiscal deficit of the states has come down from a high of 5.1 percent of GDP in 2003-04 to 2.1 percent in 2008-09. The revenue deficit too has been replaced by revenue surplus amounting to 0.54 percent of GDP in 2008-09, from a deficit of 2.6 percent in 2000-01. This is attributed to the incentive structure provided by the Twelfth Finance Commission as indicated in the time-bound measures above. In addition, there has also been a large inflow of small savings, tax devolution and, finance commission grants.

While the overall economic buoyancy improved due to the central transfers by way of tax sharing, the interest payment obligations declined due to the debt-swap scheme introduced. Most states have now agreed to mirror the centre's fiscal correction plan by putting in place their own fiscal responsibility targets.

11.5 LOCAL FINANCE

Local government bodies in India consist of various tiers of Panchayati Raj Institutions (PRIs) in rural areas and municipal bodies in urban areas. With the enactment of the 73rd and 74th Constitution Amendment Acts, local governments have attained the statutory status of the third tier of the federal structure. Their areas of responsibility have been respectively laid down, for the rural and urban local government, in the Schedules XI and XII of the Constitution.

11.5.1 State of Finances

The important sources of revenue of PRIs are: (i) house tax, professional tax, taxes on property and vehicles, etc.; (ii) fees from remunerative enterprises like markets, slaughter houses, etc.; and (iii) state grants and loans. Overall, PRI's finances have been in poor shape, so much so that they have not been in a position to discharge many of their obligatory functions like provision of safe drinking water, sanitation and conservancy.

The major sources of revenue for urban local bodies are tax-revenue (65%), grants-in-aid (25%), and non-tax revenue. Over the years, the dependence of local bodies on government grants has increased. Local governments are themselves partly responsible for this as they (i) have

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failed to administer property tax and octroi levies, (ii) could not maximise revenue from potential sources, and (iii) have failed to raise revenue from user charges.

Check Your Progress 2

1. Enumerate, in brief, the objectives of reforms in state finances.

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2. Mention in brief the results of measures undertaken to bring about reforms in state finances.

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3. Discuss in brief the state of local finance in India.

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11.6 INDIA'S TAX STRUCTURE

The Indian tax structure, like in any other country, has developed in response to many influences - social, political and economic. In analysing the tax structure, it is therefore useful to first of all note the properties of an ideal tax structure, which are as follows:

i) The distribution of tax burden should be ***progressive***.

ii) The tax structure should facilitate the use of fiscal policy for achieving ***stabilisation*** and ***growth*** objectives.

iii) The tax structure should improve ***efficiency of the market*** rather than distort it.

iv) Tax policy should be ***easy to implement administratively*** with a low cost of collection of taxes.

11.6.1 Main Aspects of India's Tax Structure

The principal aspects of India's tax structure can be briefly enumerated as follows:

1. **Increasing importance of tax revenue:** The tax revenue collected both by the Central and state Governments have increased from Rs. 460 crore in 1951-52 to Rs. 10,17,107 crore in 2008-09 registering an average annual growth of 13.9 percent (over the 59 years period). There has thus been a significant increase in tax revenue. However, looked at another way, the tax revenue which formed 88.6 percent of the total revenue receipts in 1951-52 declined to 84.1 percent in 2008-09. Two possible inferences that can be drawn from these figures are:

   a) The Central and State governments have been relying less on tax revenue to finance their expenditure; or

   b) Revenue from non-tax sources has been increasing at a faster rate.

The second of the above two inferences looks more plausible because, as noted above, the amount of taxes collected by the Central and State governments have risen appreciably over the years. Further, as stated below, the tax revenue as a percentage of national income has also been consistently rising.

2. **Tax revenue as a percentage of national income:** The total tax revenue as a percentage of GDP, has increased from 6.7% in 1950-51 to 19.2% in 2008-09. Although this is a good growth, this can be contrasted to the tax GDP ratio of developed countries which ranges between 25 and 45 percent. Again, while it is likely to give the impression that our tax effort is relatively low, it should not be ignored that in a low-income country like India, a tax GDP ratio of about 20 percent imposes quite a heavy burden on the majority of population. To understand this, we need to take a look at the 'structure of taxes' which is outlined below.

3. **Structure of Taxes:** These are classified into two types, viz. (i) direct taxes and (ii) indirect taxes. Direct taxes include taxes on income and property, whereas indirect taxes cover taxes on commodities and services. Important direct taxes are income tax, corporate tax and wealth tax. Important examples of indirect tax are VAT, service tax, excise duties, import duties, etc. Over the years, India's tax structure had come to rely more on indirect taxation. The underlying rationale was that since it is difficult to reach all the individuals, the alternative of pursuing a broad based indirect tax is preferable. However, following measures initiated in the direction of rationalisation and simplification of the tax structure, there has been a decline in the proportion of indirect taxes in the country. The trend has revealed that lower tax rates are compatible with higher tax realisation, given better tax administration and compliance.

4. **Shift in Relative Importance of Taxes:** As a consequence of the fact that indirect taxation had been increasing till the onset of 1990s, there occurred a shift in the relative importance of different taxes. For instance, corporate and income taxes which were the major source of the Union revenue during early 1950s, yielded place to excise duties and customs duties. Similarly, in the State tax structure, sales tax replaced land revenue as the major source of state revenue. The increasing importance of excise revenue and sales tax reflected the favourable changes in the economy following the progress on industrialisation and export promotion fronts. Other contributory factors for the relative shift in tax structure are: (i) the rise in domestic production and prices and (ii) extension of the tax coverage. While these developments took place up to the 1980s, with the onset of the reform in the 1990s, the relative importance of different taxes has been undergoing changes once again. For instance, the significance of personal income tax and corporate tax have been on the rise, whereas that of the customs and excise duties are on the decline.

5. **Progressive Tax Rate Structure:** The tax structure has been designed in such a manner that all *relevant ability indices* are considered. In particular, the direct tax structure has been made progressive by ensuring that as the base grows the yield will also increase. There has, therefore, been a gradual move towards presumptive methods of taxation in which factors like: (i) emergence of a service oriented economy, (ii) proliferation of small businesses, (iii) rapid industrialisation, (iv) increase in the number of taxpayers and, above all, (v) the need to device ways and means which could ensure revenue flows without much strain on the administrative set up are given due recognition. In the field of indirect taxes, on the other hand, duties have been so levied that commodities which are consumed by the relatively well-to-do classes are taxed more.

Taxation has thus been used as one of the main instruments to achieve the different socio-economic objectives of the country.

11.6.2 Evaluation of the Tax System

Evaluation of Indian tax system can be made along the following four criteria which are necessary to sub-serve the objectives of planned economic development: (1) adequacy and productivity, (2) efficiency, (3) equity, and (4) certainty.

1. **Adequacy and productivity:** Contrary to the earlier phase, tax system has exhibited a good deal of buoyancy in recent years. The tax revenue has been continuously increasing along with an increase in national income. However, the increase in tax revenue has not been adequate enough to meet the growing requirements of the developing economy.

2. **Efficiency:** Indian tax system falls short of the criterion of efficiency.

On account of complicated laws and rapid changes in their provisions, the tax system has lost the qualities of simplicity and certainty. As a result, on the one hand, this has led to massive tax evasion and avoidance. This has generated massive black money which, in turn, has given rise to serious distortions in the economic and socio-political set-up. On the other, the taxpayers have to incur high costs in paying up taxes.

3. **Equity:** Our tax system also falls short of the criterion of equity. Although our direct taxes are highly progressive, undue reliance on indirect taxes has more than counter-balanced that effect. Leaving agricultural income out of the tax net has been a source of additional inequity. Likewise, the proliferating unorganised industrial sector is providing complete tax haven.

4. **Certainty:** The scheme of taxes in India has been considerably fluctuating, resulting in frequent tampering with tax exemptions, incentives and concessions leading to uncertainty. Even the goals of taxation have been changing. For instance, at one time the goal was to have a large number of taxes, so as to widen the tax base, whereas currently, the goal is to reduce the multiplicity of taxes and duplicity of the laws. Again, at one stage, indirect taxes on commodity inputs were not only levied more but also extended widely. Presently, however, the goal of indirect taxes is to avoid the cascading effects of taxes. A more fundamental change in the tax perspective is the emphasis in the recent years on thrift, productivity and wealth accumulation as compared to the almost single most important goal of 'avoidance of concentration of income and wealth' pursued in earlier years. Adhocism pervades the sector of corporate taxation also. Although the reasons behind the changes are quite often laudable, the policy of frequent and sudden changes in taxes ought to give way to certainty so as to have stability in the tax administration system.

In short, many provisions in the tax laws have become redundant and need to be in tandem with the liberalised economic policies. In the current scenario, as suggested by Raja J. Chelliah, India's tax structure should be based on three cardinal principles; the tax system should be simple, moderate and fair. (For tax reforms in India, readers are guided to unit-12 of the course).

Check Your Progress 3

1. Enumerate in brief the salient features of Indian tax structure.

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2. Write a note on the structure of taxes in the Indian taxation system.

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3. Make a critical assessment, in brief, of India's tax structure.

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11.7 GROWTH OF PUBLIC EXPENDITURE IN INDIA

As stated earlier, India has a federal system of finance in which duties and functions of the central and state governments have been clearly distinguished. The constituents of the federal structure have been empowered to incur expenditure on the functions falling under their purview.

An analysis of the growth of public expenditure can be properly done under two headings: (i) size, and (ii) classification.

11.7.1 Size of Public Expenditure

The size of public expenditure in India i.e. the total expenditure of the central and state governments has grown from Rs. 983 crores in 1950-51 to Rs. 14,85,535 crore in 2008-09 or at an average annual growth rate of 13.5%. The growth of public expenditure has been at almost the same pace as that of revenue generation which also had grown at an average annual rate of 13.9% per annum over the period. Of course, all of this increase cannot be regarded as real, as a good part of it would be due to the rise in prices. But even if an adjustment is made for the rise in prices the fact remains that there has been a phenomenal increase in public expenditure. This fact can also be brought out in another way i.e. by relating public expenditure to GDP. Whereas GDP has increased at an annual average rate of about 4.2 percent during this period, the proportion of public expenditure in national income has gone up from 11.1 percent in 1950-51 to 28.0 percent in 2008-09. Compared to an average of 40 percent in public expenditure in industrialised market economies, once again, India's proportion of public expenditure is still low.

Plan Expenditure and Non-Plan Expenditure: The budgeted expenditure in a year is split into two parts, viz. (a) plan expenditure, and (b) non-plan expenditure.

Plan expenditure consists of budgetary provisions for schemes and programmes that have been included in the five-year plans in which the financial allocations between different heads are made on a five-yearly basis. Within the broad parameters of budgetary provision, annual allocations are made for different schemes and programmes.

Non-plan expenditure on the other hand, is a generic term which includes both developmental and non-developmental expenditure. Part of the expenditure is obligatory in nature e.g. interest payments, pensionary charges and statutory transfers to states. Part of the expenditure is on account of certain essential obligations of a state e.g. defence and internal security. Expenditure on maintaining the assets created in previous plans is also treated as non-plan expenditure. Likewise, expenditure on continuing services and activities from levels already reached in a plan period is shifted to non-plan in the next period e.g. expenditure on education and health services, continuing research projects, operating expenses of power stations, etc. Thus, as more plans are completed, a large amount of expenditure on their operation and maintenance of facilities and services created gets added to non-plan expenditure besides the interest on government borrowings to finance the plan. Therefore, as the plan size grows, expenditure under the non-plan category also grows. For instance, the non-plan expenditure of the Central Government amounting to Rs. 76,933 crore in 1990-91, increased to Rs. 5,07,498 crore during 2008-09. However, as a proportion of total expenditure, non-plan expenditure came down to 67.1 percent in 2008-09 from the 73.1 percent in 1990-91.

Non-plan expenditure has been the focus of considerable criticism from many quarters. Though much of the criticism comes from the premise that the non-plan expenditure is maintenance centred and to that extent not adding to further productive asset base, a more detailed study of non-plan expenditure shows that many of its constituent items are vital for the long-term development and social goals of the economy. The non-plan outlay may on analysis be therefore found to be as significant to the achievements of the plan as the plan outlay itself.

11.7.2 Classification of Public Expenditure

Public expenditure both at the centre and states can be classified into two categories, viz. (1) developmental expenditure, and (2) non-developmental expenditure.

Central expenditure: Developmental expenditure of the central government includes expenditure incurred under such heads as social and community services, economic services, grants-in-aid to states and Union Territory governments for developmental expenses. Non-

developmental expenditure of the central government includes expenditure incurred on defence, interest payments, etc.

State expenditure: Developmental expenditure of the state governments also include expenditure incurred on social and community services, and economic services. Non-developmental expenditure includes expenditure incurred under such heads as administrative services, fiscal services, appropriation to reserves, interest payments, pensions, etc.

The proportion of developmental expenditure in total public expenditure has shown a significant increase over the years. In 1950-51, developmental expenditure formed 36 percent of the total expenditure. In 2008-09, this proportion was estimated as 56 percent. This indicates the growing participation of the State in developmental activities of the economy. It should, however, be noted that the developmental schemes figure both under revenue and capital budgets. Although a larger proportion of developmental expenditure comes under capital budget, some parts of revenue budget such as subsidies do not directly pertain to developmental purposes although their indirect effects on development cannot be underrated.

11.7.3 Causes of Growth in Public Expenditure

The continuously rising public expenditure can be explained in terms of the Wagner's Law. According to the Wagner's law (hypothesised and empirically verified about 100 years ago by Adolph Wagner), there exists a causal relationship between government expenditure and economic development. The law specifies that: 'during the course of economic development, government expenditure increases more than proportionately with per capita community output'. In other words, the income elasticity of demand for government expenditure is more than one. The underlying explanation is that the very growth of the economy gives rise to such complexities that the government has to incur increasing expenditure to deal with them. Wagner distinguished three types of activities which cause an increase in government expenditure. These are:

i) Maintenance and enforcement of internal law and order;

ii) Participation in material production; and

iii) Provision of social services.

Each one of the above pushes up the expenditure for different reasons. The **first** one increases expenditure because government has to ensure the maintenance and improvement of the quality of services it provides. The **second** one increases expenditure because government has to create a climate conducive to economic growth by entering into material production which private sector would not undertake on its own. The **third** one pushes up expenditure because government alone has the ability to provide such services satisfactorily.

In addition, more recent research in this area has identified other factors like demographic changes, higher income elasticity of public goods, increasing cost of government production, etc. as responsible for growing public expenditure of the government.

All the above mentioned factors are interrelated suggesting that the sphere of government activity in developing economies like India is rising. The type of the mixed economy that India has adopted has opened up multiple avenues of government action ranging from direct participation in production (as an entrepreneur) to the exercise of regulatory and promotional measures (via taxes and subsidies). The objective of these activities would, therefore, range from the provision of social overhead capital to achieving of social and economic equality in the economy.

11.7.4 Need to Cut Public Expenditure

The ongoing reforms in the Indian economy underscore the need for scaling down the fiscal deficit. Theoretically, fiscal deficit can be reduced either by increasing revenues (i.e. the rate of growth of revenue generated) or by reducing government expenditures. In the present context, most of the reduction has to be achieved though the reduction of expenditure as the 'tax to GDP ratio' has already reached such a high level that it may not be desirable to raise it further.

The progress on this front in India has, however, not been encouraging as revealed by the facts that: (i) the government expenditure as a proportion of GDP has shown little change in the post-reform period, and (ii) the composition of spending is still skewed towards unproductive expenditures. Slow progress on both these fronts has rendered the task of maintaining macroeconomic stability more complicated.

11.8 PUBLIC DEBT IN INDIA

Among the non-tax sources the major source of government revenue is public debt. As per the current budgetary practices, there are three sets of liabilities which constitute central government public debt, viz. (1) internal debt, (2) external debt, and (3) other liabilities. The three sets of liabilities are as follows:

1. **Internal debt:** The internal debt is classified into: (a) market loans, (b) other long and medium term borrowings, and (c) short-term borrowings all of which are shown under the receipts side of the central budget. They include special securities and T-bills issued to RBI, state governments, commercial banks and other financial institutions.

2. **External debt:** Represents loans received from foreign government and bodies.

   Both the internal and external debt are secured under a fund called as the Consolidated Fund of India.

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3. **Other Liabilities:** Includes other interest bearing obligations of the government such as: (i) post office savings deposits under small savings schemes, loans raised through post office cash certificates, etc. (ii) provident funds, (iii) interest bearing reserve funds of departments like railways and telecommunications, etc.

The obligations of 'other liabilities' are met by the Public Account, just as the internal and external debts are secured under the Consolidated Fund.

11.8.1 Growth of Public Debt

As a means of financing, the Government of India has made a liberal use of borrowing, both internal and external, as can be seen from Table 11.4. The figures of total indebtedness and its components are of staggering magnitude. But far more important than the magnitudes are the rate at which they are growing (12.5 percent average annual growth for total debt). Public debt as a proportion of national income has increased from 12 percent in 1980-81 to 42 percent in 2008-09.

Table 11.4: Public Debt of the Government of India (As at the end of the year)

(Rs. in Crores)

Year	Internal Debt	External Debt	Total Public Debt
1950-51	2,022	32	2,054
1960-61	3,978	761	4,739
1980-81	30,864	13,479	44,343
1990-91	2,83,033	31,525	3,14,558
2000-01	8,03,697	65,945	8,69,642
2008-09	19,72,532	11,23,675	20,95,207

11.8.2 Problems of Public Debt

The growing size of public debt in India has given rise to the problem of debt management. The important objectives of debt management in the context of planned development of Indian economy are as follows:

1. Promote savings and provide more funds for investment in the public sector without impinging on the private sector's need for funds; and

2. Ensure large borrowing and other debt requirement without sacrificing the objective of price stability.

The first objective requires a debt policy capable of tapping funds from all possible sources in the economy. Varied instruments of resource mobilisation should be employed to suit the requirements of different types of savers/investors. The policy should be flexible so as to offer

terms, such as the interest rates and maturities, suitable to the conditions prevailing in the money and the capital markets.

The second objective requires that the loan operations of the government should support the objective of maintaining the price stability in the economy. In other words, these operations should have the aim of minimising the incidence of inflation.

11.8.3 Evaluation of Debt Policy

Government of India's debt policy can be evaluated on the basis of the two objectives defined above. The public debt policy has been successful in terms of the first objective as evidenced by the growth of public debt which has contributed to the resource availability of the government to meet its plan and non-plan expenditures. This is all the more creditable in view of the limited sphere of organised money market, an all-round scarcity of funds and competing claims for these funds by both the public and private sectors. It is, therefore, a commendable achievement that along with the dated loans, quite a good contribution has been made by the small savings sector.

In terms of the second objective, the policy has exhibited certain weaknesses. The rate of return on public debt has been quite low. Though this has helped the government in keeping the interest rate in check, it has prevented the expansion of the government securities market. The phenomenon has added to the inflationary pressures in the economy, making the investment in government securities less attractive. For a public debt policy to be anti-inflationary, contribution to the public debt should come from genuine savings adding to the productive capacity of the economy.

Check Your Progress 4

1. Distinguish between plan expenditure and non-plan expenditure.

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2. Distinguish between developmental expenditure and non-developmental expenditure.

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3. Examine in brief the trends in public debt in India.

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11.9 LET US SUM UP

Two major functions of a fiscal system are: (a) raising of revenue, and (b) incurring of expenditure by the government. In a federal system of governance, different governments operate at different levels. India's Constitution provides for (i) a union government, (ii) governments at state level, and (iii) local authorities. The state of finances at different levels of government has been precarious, resulting in fiscal imbalances and other distortions in the economy. Tax revenues have failed to keep pace with the ever-rising expenditure requirements of the government. There is an imperative need to bring speedy reforms in the fiscal administration of the country. This is the theme to which the subsequent unit of the course (unit 12) addresses.

11.10 KEY WORDS

Budget : Shows the relationship between estimated financial receipt and expenditure (i.e. its disbursement)

Revenue Budget : Covers those items which are of a recurring nature

Capital Budget : Covers those items relating to acquiring and disposal of capital assests

Revenue Deficit : Is the difference between the revenue receipts and revenue expenditure

Fiscal Deficit : Indicates the total borrowing requirements of government from other sources to meet the total expenditure requirements of the government

11.11 SOME USEFUL BOOKS

Amresh Bagchi (ed.), *Readings in Public Finance*, Oxford University Press (OUP), New Delhi, 2005.

Kaushik Basu (ed.), *The Oxford Companion to Economics in India*, OUP, New Delhi, 2009.

Ishwar C. Dhingra, *The Indian Economy–Environment and Policy*, Sultan Chand, 2009.

Reserve Bank of India, Annual Report.

Government on India, Union Budgets.

11.12 ANSWERS OR HINTS TO CHECK YOUR PROGESS EXERCISES

Check Your Progress 1

1. See Sub-section 11.2.1 and answer.
2. See Sub-section 11.2.2 and answer.
3. See Sub-section 11.3.2 and answer.
4. See Sub-section 11.3.3 and answer.

Check Your Progress 2

1. See Sub-section 11.4.1 and answer.
2. See Sub-section 11.4.1 and answer.
3. See Sub-section 11.5.1 and answer.

Check Your Progress 3

1. See Sub-section 11.6.1 and answer.
2. See Sub-section 11.6.1 and answer.
3. See Sub-section 11.6.2 and answer.

Check Your Progress 4

1. See Sub-section 11.7.1 and answer.
2. See Sub-section 11.7.2 and answer.
3. See Sub-section 11.8.1 and answer.

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