UNIT 14  PATTERNS OF PUBLIC EXPENDITURE IN INDIA

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14.0  OBJECTIVES

After reading this unit, you will be able to:

- define the concept of public expenditure;
- state the hypotheses (put forth by Peacock and Wiseman) on trends in public expenditure;
- describe the factors which influence large public expenditure spending in an economy;
- discuss the canons of public expenditure;
- delineate the concept of ‘division of expenditure’ between the centre and states in India;
- present an account of the trends in public expenditure over the period 1991-2015;
- distinguish between (i) revenue expenditure and capital expenditure and (ii) plan expenditure and non-plan expenditure; and
- write a note on ‘reforms in public expenditure in India’.
14.1 INTRODUCTION

Public expenditure is expenditure incurred by the government (e.g. central government, state governments, lower level governments like district office, gram panchayat, etc.). Such expenditures are made for social welfare of people and to run the government administration. The importance attached to public expenditure has varied between different schools of thought. During the laissez-faire policies of 19th century, the role of government was minimum. Over time, with the evolution of theories of public expenditure, the importance of public expenditure has come into limelight as an important tool of fiscal policy. The failure of market mechanism to ensure social welfare, income equality and full employment has contributed to the insights developed into the potentials of public expenditure. In view of these, the role of the government in public expenditure is considered crucial across the globe.

14.2 CONCEPT OF PUBLIC EXPENDITURE

World-wide, there has been a continuous increase in public expenditure. The range of activities performed by the governments span areas like national defence, police and internal security, development of education and health sectors, policies to remove poverty, etc. Several theories have attempted to explain the reasons behind the growth in public expenditure. You have already studied about them in detail in your previous Unit 13. However, we shall briefly make reference to some of the important ones below and then proceed to study the ‘trends in public expenditure in India’.

German economist, Adolph Wagner (1883), gave a law called the ‘law of ever increasing state activity’ based on the historical facts (studied primarily for Germany and some other countries). The law states that there is a persistent tendency for the scope of the government to expand because of three main factors: (i) the higher level of economic development, (ii) higher level of administrative and protective actions of the state, and (iii) due to welfare functions. The different layers of the government (e.g. Central, State and Local bodies) have a tendency to grow, both intensively and extensively (i.e. vertically as well as horizontally). By intensive growth of expenditure is meant the recurring type of expenditure such as law and order, police, defence, etc. Extensive expenditure, on the other hand, refers to the welfare related programmes and capital creation activities such as creation of schools, hospitals etc. Likewise, Peacock and Wiseman (1961) studied the growth path of public expenditure of United Kingdom from 1890-1955. They concluded that public expenditure does not increase in a smooth and continuous manner but increases in a step-like manner. They postulated three important hypotheses from their analysis. First is known as the ‘Displacement Effect Hypotheses’. This states that public expenditure is caused by growth in revenue. Large scale and unavoidable disturbances such as wars, influx of refugees, etc. force the government to undertake higher expenditure in the economy thereby placing higher taxation burden on the people. Thus, such events shift the earlier low level of expenditure and taxation to new and higher level. There is thus a ‘displacement effect’. The second one is termed as the ‘Inspection Effect Hypothesis’. Due to new level of expenditure and taxation created by the displacement effect, the economy does not go back to the earlier lower levels of expenditure and taxation even after these major disturbances are over. People develop higher tolerance towards higher taxation and as a result become habitual in course of time due to which the general level of expenditure and taxation goes
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up. Such big and unavoidable disturbances therefore force the government (and the people) to find out solutions to the problems which were neglected earlier. The third hypothesis is termed as ‘Concentration Effect Hypothesis’. This effect occurs when the central authorities have higher tendency (than sub-national or local governments) to grow faster during the periods of high growth level.

14.2.1 Factors of Influence

Several factors of demographic, political and public significance influence public expenditure. These may be stated as follows.

Growth of Population: A large and growing population is one of the main reasons behind growing public expenditure. A country with large population will have to create more schools, hospitals, transport facilities, roads and other amenities to meet the needs of its large population as compared to countries with smaller population. In order to control the population growth, the government intervenes with policies on family planning creating necessary infrastructure to administer such policies.

Growth of Democracy: The structure of the democratic form of the government is such that it will require more public expenditure. It requires regular and continuous maintenance of the political institutions. For instance, periodic conduct of elections would be required at all levels of the government. Countries with a democratic form of government will always therefore have a higher level of public expenditure. Additionally, to increase their chances of re-election local politicians will be more responsive to demands of the people in their jurisdiction. This requires the setting up of large scale ‘public goods’ in all jurisdictions which require funds on regular basis for their maintenance (called non-plan or revenue expenditure). Therefore, the political and governing structure of country always serves as a significant factor behind a large scale public expenditure.

Welfare State: The role of the state during the laissez-faire policies of 19th century was termed as a ‘police state’ where the role of public expenditure in the economic life of the people and community remained neglected. Various positive effects of public expenditure on increasing production and employment, reducing income inequality, etc. were ignored. In successive decades, the understanding of the term ‘modern state’ evolved over time. This changed the concept of ‘police state’ to ‘welfare state’ under which large emphasis is placed on the welfare related measures required to uplift the social welfare of the marginalised sections of people. For instance, creation of employment opportunities, social security measures, creation of welfare related infrastructure, etc. would all require greater role by the government. The ‘theory of public expenditure’ has therefore recognised distortions created by ‘market mechanism’ in ensuring full employment of job seeking population. Due to these factors and increased sensitisation for the welfare of people, the extent of public expenditure incurred has increased enormously over the years.

Defence Expenditure: In modern society, every country wants to protect its borders. The possibility of wars require the nations to equip themselves with arms. This process, in turn, requires large scale public expenditure to equip their defence sector.

Expansion of Public Sector and Administrative Set up: Creation of large scale administrative set up requires large scale public expenditure. This is more likely for countries with large geographic area with decentralised government systems
(e.g. Canada, Australia, India). This entails expenditure on large scale police and public services machinery in every nook and corner of the country to maintain internal security, public administration, public sector enterprises, etc.

**Poverty Alleviation Programmes:** Countries which have chronic poverty have to incur large scale expenditure in the form of poverty alleviation programmes. This is especially so for countries like India (and other developing countries) which rely heavily on public programmes to improve the well-being of their poorest so as to bring them up to join and benefit from the mainstream development process of the country.

**Urbanisation:** Countries with a larger, and especially growing, urban population also require growing public expenditure to expand their urban amenities (such as establishment of better quality schools, drainage system, hospitals, drinking water facilities, better law and order condition in the society, etc.).

**Income Re-distribution:** Policies targeted for income re-distribution collect taxes from richer states and spend them in poorer states leading to transfer of funds. For instance, government collects taxes from richer areas with proceeds from certain taxes earmarked to be spent for the development of poorer regions. This is needed because such regions cannot raise enough funds from their own jurisdiction due to lower level of development. The extent of public expenditure is therefore large in such a federal set up.

### 14.3 CANONS OF PUBLIC EXPENDITURE

Public expenditure should satisfy certain canons (or principles) of public expenditure. These are the guiding principles about how the public expenditure policy of the governments should be administered. Professor Alfred G. Buchler made some guidelines for expenditure by the public authorities. These are: (i) public expenditure should promote the welfare of the society; (ii) careful judgement should be exercised to ensure that the advantages of the public expenditure exceed the costs; (iii) the fund utilised by the governments should be more conducive to social welfare (than when the same funds were utilised for private welfare); and (iv) public expenditure should be utilised in the order of priority of welfare i.e. the services which will bring about maximum welfare gains should be undertaken first. Prof. Findlay Shirras specified these as canons in terms of four principles of public expenditure as follows.

**Canon of Benefit:** The ideal of this is maximum social advantage. If a particular group in a community gets more benefit from public expenditure at the expense of the whole society then that cannot be justified by the principle of ‘maximum social advantage’. Hence, public expenditure should be planned in such a way that it yields maximum social benefit in terms of the social welfare of the community as a whole and not of a particular group. Public expenditure must therefore be spent in those directions which will maximise utility. It should aim to increase production, reduce income and wealth inequality in the society, enhance quality of social life, etc.

**Canon of Economy:** The canon implies that the government should be economical in spending money. By economical means, the expenditure should avoid extravagance and wastage of public money. Government should not spend more than the necessary amount required because any such activity can lead to wastage of public fund and corruption. Additionally, the social benefit can be maximised when resources are not wasted. The canon of economy therefore calls for efficient public finance authorities.
Canon of Sanction: According to this canon, no expenditure should be incurred without the proper approval of the sanctioning authority. This ensures that the money is spent on authorised heads of expenditures allowing for a smooth auditing of public accounts at the end of each financial year. As a rule, therefore, money must be spent on the purpose for which it is sanctioned by the authority and accounts maintained must be properly audited. Since unauthorised spending leads to extravagance and over-spending, this canon acts as a check on arbitrary, unwise and reckless spending of public funds.

Canon of Surplus: This canon believes in the avoidance of deficit in public expenditure. In other words, government should aim at achieving balanced budget where public expenditure is lower than or at most equal to public revenue. If public expenditure exceeds public revenue by a large gap it will lead to government debt and might impact the fiscal sustainability of the government.

Besides the above four canons, there are also some other canons of public expenditure. These are as follows.

Canon of Productivity: Public expenditure should be incurred in such a way that promotes production and creates employment opportunities in the economy. It should lead to capital formation and increase the working efficiency of the people. Development activities should be given priority in the government budget. In other words, the aim of public expenditure should be maximum production, employment and income.

Canon of Elasticity: This canon requires that the government should not spend public money in a rigid manner; rather, it should be flexible. This means that the government should be able to vary the amount of expenditure as per the need of the situation. For instance, government should be able to increase public expenditure during periods of emergency such as war, flood, drought, etc. or during economic depression when the economic growth is low. An increase in government expenditure during the time of depression ensures that the economy is lifted from low levels of production and employment. The multiplier effect of the public spending will pave the way for economic recovery. The opposite is the case during the period of boom and high inflation when government should reduce public expenditure. In other words, public expenditure should be elastic which can be used as a fiscal policy instrument to stabilise the economy during the time of high inflation or depression.

Canon of Equality: This canon implies that public expenditure should be incurred in such a way as to reduce inequality in the distribution of income and wealth. It should not lead to accumulation of income and wealth by a small segment of the society. In order to achieve equality of income, government should direct its public expenditure towards the welfare and economic progress of those sections of the society who are lagging behind on economic front.

Canon of Neutrality: The canon of neutrality states that public expenditure should have a desirable impact on the economy and not any un-desirable impact. This means that public expenditure should increase production and productivity and not reduce it. Similarly, it should reduce income inequality and not increase it. In other words, public expenditure should not worsen the production-distribution-exchange relationship but improve it.

Canon of Certainty: The public authorities should be clear about the purpose and extent of public expenditure to be incurred. The canon requires the preparation of public budgets with the government taking into account both the short term and
long term impacts of public expenditure with the modes of spending clearly spelt out.

Check Your Progress 1 [answer within the given space in about 50-100 words]

1) State the three factors mentioned by Wagner in support of his law on ‘ever increasing state activity’.

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2) What is meant by ‘creation of large scale public goods’ prompting higher spending of public expenditure in economies following a democratic system of governance?

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3) What does the ‘canon of benefit’ principally require?

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4) Which canon acts as a check on ‘arbitrary, reckless and unwise spending of public funds’?

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5) Which canon public expenditure should fulfil in order that it can be used as an instrument of fiscal policy during the time of high inflation and depression?

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14.4 TRENDS IN PUBLIC EXPENDITURE IN INDIA

India with 29 States and 7 Union Territories has a quasi-federal structure which specifies three characteristics for different tiers of governments: (i) division of functional responsibilities, (ii) assignment of autonomous revenue sources and (iii) system of inter-governmental fiscal transfers. All these functions are important to ensure a sound fiscal environment not only at the central level but at the lower levels as well. These three characteristics connect the different layers of governance structure in India.

14.4.1 Division of Expenditure Between Centre and States

Expenditure areas of central and state governments are specified in the Union list and State list respectively. Subjects like defence, macroeconomic stability, money and banking and international trade are assigned to the central government in the Union list. The stabilisation function dealing with the macroeconomic aspect relates to the use of budgetary policy as a means of maintaining ‘high employment, price stability and an appropriate rate of economic growth’. The subjects where benefits of public expenditure can spillover to more than one state are also assigned to Central government (e.g. railways, defence, national highways, atomic energy, space, shipping and inland water ways). The functions entrusted to the state governments include: (i) maintaining public order, (ii) agriculture sector, (iii) public health and sanitation, (iv) water supply, irrigation and canals. The powers falling in common jurisdiction are specified under concurrent list and these include education, transportation and social insurance. Thus, under the quasi-federal structure of India, majority of the powers lie with central government which got strengthened with the concept of centralised planning. However, due to the decentralised set up of Indian economy, large proportion of aggregate expenditure in economy is undertaken at sub-national level.

A realistic question that therefore arises is: why is public expenditure incurred by the sub-national governments and what is the economic rationale underlying it? This is explained by the Decentralised Theorem. The most important task with the government is of production and allocation of goods and services. The objective of public expenditure is to generate the provision of public goods whose demand could be varying as per the geography, political scenario, demographics, occupational structure, socio-economic preferences, etc. For instance, a community with younger population would require more schools and colleges as compared to community with large population of old people which would require more hospitals, old age homes and social security pension related policies. With this in view, Musgrave argued that the responsibility of incurring expenditures in line with local demand should be assigned to the sub-national governments. The local politicians, being nearer to the local residents, could evaluate the need for local public goods more efficiently. Hence the decentralised provision of public goods is seen as the best option since it could identify and satisfy the geographically varying demands for public goods generating, in the process, maximum social welfare than a centralised provision of a uniform public good.
14.4.2 Changing Pattern of Public Expenditure in India

Before independence, the focus of the British government was on defence and civil administration of the country. A large part of the public expenditure was, therefore, devoted towards these services. However, since Independence, the prime objective of both the central and state governments has been higher spending on social development to eradicate poverty. The role of public expenditure to achieve these targets has thus varied across the different phases of economic development in India.

The pattern and focus of public expenditure has changed over each ‘five year plan’ in order to address the immediate need of the country at that time. For instance, the focus of the government in first five year plan (1951-56) was on the development of agriculture sector including irrigation and power. The second five-year plan (1956-61) focussed more on industrial development including heavy and basic industries. The fifth five-year plan (1974-78) proposed to achieve the two targets of ‘poverty eradication’ and ‘attainment of self-reliance’. From 1980 onwards, there was high rise in public debt and large interest payments. This guided the government to set up policies which could reduce the fiscal deficit and stabilise growth. The government, therefore, introduced a program of macroeconomic stabilisation in July 1991. Following this, the economy was gradually opened up as a part of new economic policy of ‘liberalisation, privatisation and globalisation’. With this, the focus of the public expenditure in the eighth plan (1992-97) was shifted to ‘removing infrastructure constraints’. A large part of public expenditure was devoted for energy, transport and communication sector. This momentum continued in the ninth plan (1997-2002). This overview thus gives us a picture of how the government priorities contributed to shaping the growth of public expenditure in the Indian economy.


<table>
<thead>
<tr>
<th>Year</th>
<th>Central Government Expenditure</th>
<th>Combined State Government Expenditure</th>
<th>Centre + States Combined Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>16.6</td>
<td>16.0</td>
<td>26.5</td>
</tr>
<tr>
<td>1995</td>
<td>14.4</td>
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<td>2010</td>
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<td>14.6</td>
<td>26.6</td>
</tr>
<tr>
<td>2011</td>
<td>14.1</td>
<td>14.6</td>
<td>25.8</td>
</tr>
<tr>
<td>2015</td>
<td>13.1</td>
<td>18.7</td>
<td>27.7</td>
</tr>
</tbody>
</table>

*Note:* Figures are percentage to GDP.
*Source:* RBI and EPW Foundation.

The historical importance of public expenditure lies in the mixed economy model adopted after Independence in India. Under this, the government assumed the primary responsibility of building the capital and infrastructure base to promote economic growth. The public expenditure in India, relative to GDP, shows that for central government it has declined from 17 percent in 1991 to 13 percent in 2015 (Table 14.1). For state governments too, it has declined from 16 percent in 1991 to 15 percent in 2011 but has increased to 19 percent in 2015. The decline in the
The share of central expenditure over 2011 to 2015 and the corresponding increase in the states’ expenditure is largely due to increased financial devolution to states from the centres’ proceeds [conferred by the 14th Finance Commission (it was increased from 32 percent to 42 percent)]. The ratio of the total expenditure (centre + states) to GDP has roughly remained the same (26 percent) over the period 1991-2011 but marginally increased to 28 percent in 2015.

From the point of view of achieving the Millennium Development Goals, expenditure categories of high importance are the sectors of education and health. Other important sectors for higher public expenditure are agriculture, transport and communication. One main concern has been the rising debt burden over time due to a significant part of total public expenditure going towards ‘interest payments’. From the point of view of sound public finance principles, it is always recognised that a large debt burden would shrink the availability of funds for development expenditure. This makes it important (for all tiers of governments) to keep the debt burden under control.

14.4.3 Revenue Expenditure and Capital Expenditure

The Union budget in India classifies the total public expenditure into two components: revenue expenditure and capital expenditure. The former is committed expenditure and less productive. Expenditure categories such as pensions, salaries, subsidies, interest payment, etc. come under revenue expenditure. These do not lead to the creation of productive assets but have to be incurred in a recurring manner year after year. Capital expenditure, on the other hand, leads to creation of assets. These are expenditures incurred on creation of real capital assets or financial assets (e.g. expenditure on purchase of land, buildings or machinery, expenditure on building schools and hospitals, government investment in shares or expenditure which reduces liabilities such as repayment of loan). Capital expenditure is, thus, generally a long term expenditure.

The capital expenditure is always outweighed by revenue expenditure. This is despite the emphasis of the government towards increasing the share of capital expenditure (CE) relative to revenue expenditure (RE). The ratio of RE to CE (RE/CE) for central government was close to 2 until 1985. This was indicative of the fact that the share of revenue expenditure in total expenditure was nearly double that of capital expenditure. The gap between RE and CE for the centre widened post-1985 to touch a high of 8+ by 2009. This indicates that the share of capital expenditure relative to revenue expenditure has been steeply declining over time. A similar picture is evidenced for state government accounts where the RE/CE ratio (which was above 2 even in 1970s) has been increasing post-1980 to touch a peak of more than 5 around the year 2000. This indicates that the share of capital expenditure in total expenditure for all state governments is also declining as compared to the share of revenue expenditure.

14.4.4 Plan Expenditure and Non-Plan Expenditure

The expenditure categories of revenue and capital expenditure are further divided into plan and non-plan expenditure. Plan expenditure refers to the part of expenditure which is incurred on planned schemes or projects designed under the five-year plans. It includes current development outlays and investment outlays on two main accounts: first, it comprises of ‘central plans’ on agriculture, irrigation projects, rural development, transport, communications, etc.; and second, it includes ‘central assistance’ (i.e. grants) provided by the central government to the
States and Union Territories for their development plans. Non-plan classification refers to that part of expenditure which is incurred outside the five-year plan schemes. These are expenditures on items which are more or less committed.

A High Level Expert Committee on Efficient Management of Public Expenditure (HLEC, 2011) observed that the Plan/Non-Plan bifurcation of expenditure has contributed to a fragmented view of budget allocation hindering the process of estimating the cost of delivery and hampering the linking of budget allocation to the outcomes. The HLEC has further observed that ‘out of total expenditure, the plan expenditure constitutes only 30 percent’. Since the outcome of a scheme depends on total expenditure and not just on plan expenditure, the HLEC has held that the plan and non-plan classification is not providing a clear picture of development and non-development dimensions of government expenditure. It has, therefore, recommended to remove the plan and Non-plan classification from both central and state budgets.

**Check Your Progress 2** [answer within the given space in about 50-100 words]

1) What has been the trend in the ‘ratio of public expenditure to GDP’ over the period 1991-2015 between the centre and the states?

2) To which factor can you attribute the increase in the share of state governments (combined) towards the end of 2015?

3) Which particular factor has been among the main reason for concern in the matter of public expenditure?

4) What was the observation of HLEC, 2011 on the bifurcation of expenditure into plan and non-plan?
5) Why did HLEC, 2011 recommend the removal of plan and non-plan distinction in public expenditure?

14.5 REFORMS IN PUBLIC EXPENDITURE IN INDIA

Development expenditure incurred by both the Centre and State/UT governments consist of large number of welfare schemes which could either be a central or a state or a joint initiative. The plan schemes in Union budget are listed under two categories: (i) Centrally Sponsored Schemes (CSSs) and (ii) Central Schemes (CSs). The former are implemented by state governments. Examples of CSS are MGNREGA and SSA. CSs are implemented directly by Central government. Fertilizer subsidy and Food Subsidy are two examples of CSs.

Welfare schemes are spread across departments with eligible beneficiaries varying from scheme to scheme. Likewise, the benefits delivered under these schemes also vary [e.g. money is disbursed in schemes like MGNREGA (as wages to beneficiaries]. A large number of schemes disburse benefits in kind (e.g. PDS, Mid-Day Meals, fertilizer subsidy, etc.). Lack of transparency in fund transfer, poor monitoring and evaluation, lack of emphasis on the outcome of schemes, etc. have been the main concerns in the functioning of CSSs.

A Committee in 2005 suggested major reforms like: (i) limiting the CSSs and initiating a new CSS only with due consultation with the states; (ii) conducting ‘zero base budgeting’ (ZBB) exercise every five years; (iii) notifying the terminal dates of CSS, targeted outcomes and strategy to measure the outcome; etc. Following this, the number of CSS which was about 360 during ninth five year plan were reduced to 155 during tenth plan (2002-07) and to 147 during eleventh plan (2007-12). However, over the years a number of new schemes have been added to the list.

14.6 LET US SUM UP

Over time, with the developments in the theories of public expenditure, the significance of public expenditure has come to be recognised as an important tool of fiscal policy. The failures of market mechanism to ‘increase social welfare, reduce income inequality and ensure full employment’ have led to the insights into the potential of public expenditure and the role of the government sector in this regard. Various rules and principles have been evolved to guide a government
for efficient expenditure practices and results. In India, with adoption of the mixed economy model after attaining Independence, various needs of the economy have determined the size and composition of public expenditure over time. In the post-reform years, from the point of view of achieving the Millennium Development Goals, social sectors of education and health have received priority in public expenditure. One area of concern has been the rising debt burden over time, which has led to significant share of public expenditure going towards ‘interest payments’. One of the main objectives of the government has been to reduce its debt burden. Several reforms have been undertaken to streamline the public expenditure.

### 14.7 KEY WORDS

<table>
<thead>
<tr>
<th><strong>Public Expenditure</strong></th>
<th>Expenditures incurred by the government for the social welfare of the people.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Division of Expenditure</strong></td>
<td>Delineation of items of expenditure to be incurred by the central and state governments.</td>
</tr>
<tr>
<td><strong>Revenue Expenditure</strong></td>
<td>Recurring expenditure incurred on pensions, salaries, subsidies, interest payment, etc. These are considered non productive in the sense of capital expenditure.</td>
</tr>
<tr>
<td><strong>Capital Expenditure</strong></td>
<td>Expenditures leading to the creation of capital or financial assets. These are usually long term expenditure.</td>
</tr>
<tr>
<td><strong>Plan Expenditure</strong></td>
<td>Refers to the part of expenditure incurred on the planned schemes or projects designed under the five year plans.</td>
</tr>
<tr>
<td><strong>Non-Plan Expenditure</strong></td>
<td>Refers to expenditure incurred outside the five year plan schemes.</td>
</tr>
</tbody>
</table>

### 14.8 SOME USEFUL BOOKS


### 14.9 ANSWERS OR HINTS TO CHECK YOUR PROGRESS EXERCISES

Check Your Progress 1

1) Level of economic development, level of administrative and protective actions of the state and welfare functions.
Public Expenditure, Debt and Deficits

2) This refers to the response of local elected representatives in their re-election interest requiring regular funds to maintain them.

3) Increase production, reduce income and wealth inequality, enhance quality of social life, etc.

4) Canon of ‘sanction’.

5) Canon of ‘elasticity’.

Check Your Progress 2

1) Decline from 17 percent to 13 percent for centre and increase in that of states’ from 16 to 19 over the period 1991-2015.

2) Recommendation of 14th FC increasing the states share from 32 percent to 42 percent.

3) Debt burden and the consequent rise in the share of interest payments.

4) It contributed to a fragmented view. It further observed that plan expenditure is only about 30 percent of total expenditure.

5) Because it was not providing a clear picture of development and non-development dimensions of government expenditure.