ISSUES IN FISCAL POLICY

SUDIPTO MUNDLE
M. GOVINDA RAO

NO. 12 NOVEMBER, 1992

"ISSUES IN FISCAL POLICY"

INTRODUCTION

The eighties were a period of buoyant economic performance, the average growth rate for the decade being higher than that for any past decade. Yet, when oil prices doubled within a few weeks following the Iraqi invasion of Kuwait in August, 1990, the country very quickly slipped into the worst economic crisis that it has experienced since the mid-sixties. However, this apparent paradox could not have come as a surprise to any one who was familiar with the fragility of the underlying fiscal condition. This paper discusses the nature of this fiscal crisis (part 1) and related issues in the growth and composition of public expenditure (part 2); the tax system and mobilisation of tax revenues (part 3); non-tax revenues, subsidies and the role of user charges for publicly provided goods and services (part 4). Issues relating to finances of the States, which are in some ways even more problematic than the finances of the Central Government, are taken up in the final section (part 5).

1. The Emergence of a Fiscal Imbalance

The state dominated, heavy industries based, Nehru-Mahalanobis strategy of protected industrialisation, which India has pursued since the mid-fifties, required not only a high rate of domestic savings and investment but also a large share for the public sector in total investment[1]. While there may have been some deviation from time to time between the precise plan targets and actual performance, these objectives have been by and large satisfied. Thus, the investment rate rose from only 10 per cent of GDP in the early fifties to about 20 per cent by the mid-seventies, finally reaching a plateau at around 23 per cent during the eighties. The domestic savings rate also rose from around 10 per cent to 21 per cent over the same period, with external capital inflows usually accounting for less than 2 per cent of total investment. The public sector share of total investment also rose from less than a third in the early fifties to about one half during the eighties.

However, the public sector's own savings performance has been quite disappointing. Though public sector savings have been less than public investment throughout the planning period, this gap widened considerably during the eighties. The share of public sector in gross domestic savings declined from over 20 per cent at the beginning of the decade to only 8 per cent by 1989-90[2]. In plan financing, while the Sixth Plan (1980-81 to 1984-85) envisaged that over 46 per cent of the public sector plan outlay would be financed by own resources of the public sector, the actual contribution turned out to be only 37 per cent. Similarly, during the Seventh Plan (1985-86 to 1989-90) only 27 per cent of the public sector plan outlay was financed from own resources as against a target of over 41 per cent.

Savings performance has fallen short of expectations both for public enterprises as well as the government. In the case of public enterprises, 236 Central Government enterprises yielded a net profit of Rs. 2368 crore in 1990-91, implying a rate of return of only 2.3 per cent on Rs. 101,797 crore capital employed. Of this, only 69 crores came from all the non-oil public enterprises put together. The record of the State level enterprises is worse. The departmental commercial undertakings of all States and Union Territories together reported a net loss of Rs. 1885 crore in 1990-91. Of the two major types of non-departmental undertakings, the State Electricity Boards reported a combined loss of Rs. 4169 crore while the State Road Transport Corporations reported a loss of Rs. 470 crore. Thus, instead of generating a surplus, all public enterprises put together generated a net loss of some Rs. 4176 crore[3].

In government proper, let alone financing any capital expenditure, revenue receipts have even fallen short of revenue expenditure during the eighties. The budget of the Central Government has been showing a revenue deficit regularly since 1979-80 and now amounts to about 2.5 per cent of GDP. The combined finances of all the States and Union territories also started showing a revenue deficit from 1987-88 onwards, which now amounts to over 1 per cent of GDP.

In other words, during the eighties the government had to resort increasingly to borrowed funds to finance not only capital expenditures, which did not yield adequate returns, but also a growing component of current expenditure. The consequent build up of public debt and the interest burden of the debt, which is now the largest and fastest growing item of expenditure, further fueled the growth of revenue expenditure. This led to a vicious spiral of growing deficits, rising debt, rising interest costs and further expansion of the deficit. By 1989-90, the last year for which revised estimates are now available, the combined fiscal deficit of the Centre and States had risen to around 10 per cent of GDP.

There are several consequences of this fiscal imbalance, which is now sought to be corrected by the on-going stabilisation - adjustment programme. Most studies have shown that the present path of public debt expansion is not sustainable[4]. In addition, the imbalance has also set the economy on a medium term path of stagflation along with a severe balance of payments problem. Growing revenue deficits, combined with losses of public enterprises, have constrained the acceleration of public investment. At the same time the large public draft on private savings has tended to push up even administered interest rates and crowd out private investment. This has limited the growth of productive capacity on the supply side, while the large deficits have continued to drive the high growth of aggregate demand. The widening gap between domestic absorption and domestic output has led to a growing trade deficit and aggravated the balance of payments problem arising from indiscriminate external commercial borrowing. To the extent these have been suppressed through import restrictions, excess demand in the home market has reinforced the cost push effects of administered price increases and exchange rate depreciation in pushing up the inflation rate[5].

The growing fiscal deficit should not, however, be taken to imply that the level of tax revenues is inadequate. The tax to GDP ratio rose from 6 per cent in 1950-51 to about 11 per cent by 1970-71 and further to about 17 per cent in the eighties. This seems quite high in comparison with other countries at similar levels of per capita income. As far as the Centre is concerned, the Long Term Fiscal Policy set a target that Central Government Revenue (net of States share) should rise from 7.8 per cent to about 9.4 per cent of GDP over the Seventh Plan period (1985-86 to 1989-90). These targets were exceeded by actual achievements in every year of the Plan.

This is not to suggest either that the existing composition of taxation is appropriate or that the current tax structure is efficient. There are a number of serious anomalies which require urgent reform. These are discussed in the third part of this paper. However, the principal factor underlying the fiscal imbalance described above is the runaway growth of public expenditure which is discussed immediately below.

2. The Growth of Government Expenditure

The accelerating growth of government expenditure is a relatively recent phenomenon. In the early seventies aggregate government expenditure was actually declining in real terms. It was only in the late seventies, when nominal expenditure growth accelerated to over 13 per cent per annum, that real expenditure also started growing quite rapidly. After 1979 the nominal expenditure growth rate accelerated still further to 18.6 per cent. But by this time the trend inflation rate had also risen, not least because of the governments' own expansionary policies. Hence real expenditure growth remained stable. However in the period after 1983, the rate of growth of real expenditure has also accelerated (Table 1).

It is this progressive acceleration of government expenditure growth which has led to the emergence of a fiscal crisis despite a steady increase in the tax : GDP ratio, which exceeded the Long Term Fiscal Policy targets in every year of the Seventh Five Year Plan. Strategies for resolving the fiscal crisis will therefore have to focus on compressing the growth of public expenditure. It is interesting to note in this context that during the past four decades of 'planned' economic development, much of the literature on public finance in India was preoccupied with questions of resource mobilisation. Relatively little attention was paid to the growth, allocation or efficiency of public expenditure[6].

In addressing the question of expenditure growth and its containment it is useful to proceed from trends as observable in the economic and functional classification of government expenditure. Mention was made earlier of the equity objective of fiscal policy. The burden of international experience suggests

TABLE 1

Growth of Government Expenditure

	State and Central Governments		Central Government	
	Nominal	Real	Nominal	Real
1971-74	7.6	-6.5	4.1	-10.1
1974-79	13.3	6.9	9.1	2.6
1979-83	18.6	6.9	20.1	8.1-
1983-87	17.2	9.5	18.5	11.5

Note: Real expenditure measured at 1970-71 prices. Growth rates have been estimated by fitting a kinked exponential growth curve.

Source: Based on data provided by Central Statistical Organisation, Ministry of Planning, Government of India.

tat this is best served through expenditure policies rather than revenue measures (Gillis, 1989). In India also all evaluations, including those undertaken by reputed experts outside the government, show that despite the much talked about inefficiencies and leakages in anti-poverty programmes, these programmes have had a major role in reducing the incidence of poverty, especially during periods of drought and distress (Minhas, Jain and Tendulkar, 1991). However, these programmes are only short term relief measures. In the long run it is the expenditure on primary education, health and related activities which have a strong egalitarian impact. The anti-poverty programmes, together with the expenditure on these social services, constitute what may be called the redistributive package. How has our public expenditure pattern fared on this score?

The functional classification of expenditure reveals that, measured at 1970-71 prices, the real per capita expenditure on anti-poverty/employment programmes, shown here as transfers under agriculture and allied activities, was only Rs. 3 in 1987-88 (Table 2). Adding to this about 40 per cent of the education expenditure which goes to primary education and the entire spending on health (even though only a part of this is spent on the poor), the real per capita expenditure on the total redistributive package amounted to only Rs. 29, as against Rs. 43 per capita spent on defence and another Rs. 35 on general administration. Clearly, the redistributive package is one area of public expenditure which must not only be protected but actively expanded, even while overall expenditure growth is compressed. This is all the more urgent during a programme of stabilisation and adjustment in order to ensure that the burden is not passed on to the poor.

TABLE 2

Per Capita Expenditure by Functional Categories
States and Centre

(Rupees at 1970-71 Prices)

	1971-72	1975-76	1980-81	1985-86	1986-87	1987-88
1. Interest payment	14	11	16	29	35	39
2. Defence	25	26	27	41	40	43
3. General Administration*	36	22	25	36	35	35
4. **Economic Services**	87	66	85	111	107	104
4.1 Agriculture and allied@	32	16	22	25	30	27
4.2 Mining and manufacturing	22	21	23	38	32	30
4.3 Transport	15	10	12	12	12	11
4.4 Energy	9	10	16	22	20	21
4.5 Other economic service	8	7	9	12	10	12
5. **Social Services**	35	35	49	70	71	74
5.1 Education	20	21	27	37	37	40
5.2 Health	4	5	7	9	9	10
5.3 Housing	4	5	8	14	13	13
5.4 Other social services	7	4	7	10	12	12
6. Transfers under agriculture and allied activities	1	1	2	2	3	3
Total Expenditure	198	160	201	287	287	295

Notes: * Includes relief and miscellaneous expenditure
@ Excludes transfers

Source: Based on data provided by Central Statistical Organisation, Ministry of Planning, Government of India.

A second area of concern is the squeeze on capital expenditure. The functional classification of expenditure shows that real per capita expenditure on agriculture (which includes irrigation) and transport services has declined even in absolute terms (Table 2). This is a very serious development and reflects mainly the declining share of capital expenditure in total government expenditure. As revealed by the economic classification of expenditure (Table 3), in less than twenty years, from 1971-72 to 19870-88, the share of capital expenditure has shrunk from over 56 per cent of total Central Government expenditure to only 30 per cent, crowded out by dramatic increases in the share of interest payments, subsidies and compensation to government employees.

This treatment of capital expenditure, as well as maintenance expenditure, as residual items, chopped at will to accommodate the growth of so called `committed´ items of revenue expenditure, has had a telling impact on the nation´s infrastructure. The deteriorating condition of roads, widespread and frequent load shedding or tripping because of power shortage, bottlenecks in rail transport and telecommunication have all combined into a formidable and binding supply side constraint on economic growth. The slow down in expansion of irrigation is now threatening the growth of food supply (Rao, Hanumantha, 1992), while the scarcity and deterioration of physical facilities such as hospitals and school buildings has led to a progressive decline in the quality of these critical social services.

TABLE 3

Economic Classification of Government Expenditure

(Per cent)

	Centre						All Governments					
	1971-72	1975-76	1980-81	1985-86	1986-87	1987-88	1971-72	1975-76	1980-81	1985-86	1986-87	1987-88
1. Revenue Expenditure	43.82	57.36	61.38	63.53	64.76	69.55	53.00	61.87	63.39	66.00	66.99	70.46
1.1 Consumption expenditure	23.50	34.46	32.29	30.17	28.66	30.62	29.82	36.84	34.98	33.9	32.84	33.95
1.11 Compensation to government employees	13.67	19.39	17.89	15.39	14.35	15.79	19.20	24.44	23.86	22.30	21.85	22.80
1.12 Goods and services	9.84	15.07	14.40	14.78	14.31	14.83	10.62	12.40	11.11	11.64	10.99	11.15
1.2 Interest payment	8.43	9.93	13.21	13.95	17.43	19.29	6.89	6.74	7.21	9.05	10.78	11.77
1.3 Subsidies	6.14	9.04	12.07	14.70	14.10	14.85	4.41	5.64	8.69	11.32	10.84	11.43
1.4 Transfers	5.75	3.94	3.81	4.70	4.57	4.80	11.88	12.65	12.52	11.69	12.53	13.32
2. Capital Expenditure	56.18	42.64	38.62	36.47	35.24	30.45	47.00	38.13	36.61	34.00	33.01	29.54
3. Total Expenditure	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Note: The proportions have been worked out at constant (1970-71) prices.

Source: Based on data provided by Central Statistical Organisation, Ministry of Planning, Government of India.

Clearly, while an attempt is made to contain the growth of total expenditure, the shares of the redistributive package and capital expenditure on essential infrastructure must be raised. The obvious candidates for overall expenditure compression are therefore the three main items of revenue expenditure which account for about 70 per cent of total government expenditure, i.e., major subsidies, interest payments and compensation to government employees. Practical proposals as to how such compression might be achieved have been detailed elsewhere and need not be repeated here[7]. However, these may be briefly listed as follows:

i. Phasing out of remaining export subsidies with further progress towards convertibility and tariff rationalisation which would make subsidy incentives unnecessary.

ii. Phasing out of the fertiliser subsidy over a three year period along with increased allocation for capital expenditure in irrigation.

iii. Drastic cuts in fresh recruitment of government staff along with abolition of large numbers of posts which have proliferated in recent years. This measure, combined with the normal attrition of government employees every year would arrest the growth of wages and salaries and associated expenditure on consumption of goods and services. These now account for about a third of total government expenditure. It must be emphasised that these economies could be brought about without any harsh measures like retrenchment, or a freeze on real wages.

iv. Reduction of budgetary support to public enterprises other than in key infrastructure sectors. Even key sector enterprises like the railways, state electricity boards and road transport undertakings should be systematically nudged towards commercial viability based on improved efficiency and proper user charges. This is discussed further below in sections 4 and 5 of the paper.

v. Reduction of the interest burden through quick retirement of a part of the public debt. 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 government.

vi. Reduction of the interest charges (net of RBI dividends) payable on government debt to the Reserve Bank of India. This monetised debt has arisen out of seigniorage and should not be treated at par with other public debt.

A number of these measures have already been initiated in the July, 1991 and March, 1992 budgets and it may be expected that they would be sustained in the period ahead. However, while no serious effort has yet been made to compress government consumption expenditure the share of redistributive expenditures like the employment programme, education and health has been reduced in the March 1992 budget. It was pointed out in the Finance Minister's budget speech that many of these redistributive programmes are in fact operated by the States. It remains to be seen whether the State budgets, which are still being finalised at the time of writing, make adequate provisions for such programmes.

3. The Tax System : A Critical Evaluation

We now turn to the revenue aspects of fiscal policy, starting with an analysis of the tax system. This is important not so much to improve revenue productivity, but to identify and rectify the sources of distortion and inequity. In terms of both the level of taxes and their growth, the performance of India's tax system has been quite satisfactory. The tax ratio rose from 9 per cent in the early sixties to as much as 17 per cent in 1990-91. This is appreciably higher than the average rate of 12 per cent for countries at a comparable level of development. However, three disconcerting features must be noted. First, the tax ratio has been stagnant since the mid-eighties. Even to maintain this ratio, substantial discretionary measures had to be resorted to every year. Second, the increase in tax ratio has been accompanied by a significant increase in the share of indirect taxes, particularly import duties. Third, the tax system has been inequitous and has caused serious distortions in the incentive structure and investment decisions.

The evolution of India's tax system is at variance with the general experience of other developing countries. Instead of increasing along with growth in incomes, the share of direct taxes has declined steadily from about 30 per cent in the early sixties to just about 14 per cent in 1989-90. The share of customs duty, in contrast, increased from about 14 per cent in the early sixties to over 23 per cent by 1989-90. This too is quite different from the usual pattern of a steadily declining share of international trade taxes as development proceeds (Hinrichs, 1966).

Like in other developing countries, the establishment of a broad-based, simple and neutral tax system in India is constrained by the existence of a large traditional economic sector, low literacy level, a weak information system and powerful distributional coalitions[8]. In addition to these, the requirement of large resources for plan financing, the pursuit of multiple objectives through tax policy and the tax arrangements of a federal set up have also had to be accommodated in the Indian tax structure. The resulting tax system is extremely complicated. It has a narrow base and it has created considerable distortions in the relative price structure. Each of these issues is discussed in turn below.

The tax base is narrow for both direct and indirect taxes. In the case of personal income tax, the exclusion of tax on agricultural incomes, administrative difficulties of taxing the unorganised non- agricultural sector, provision of exemptions and deductions for various purposes and difficulties in reaching the 'hard-to-tax' groups have rendered the tax base extremely narrow. Similarly, generous deductions for depreciation and reinvestment, and contributions to a wide variety of social purposes has eroded the corporate tax base. In the case of indirect taxes, most of the services are completely excluded from the base and even the retail general sales taxes have ceased to be either 'general' or 'retail', with the point of levy being shifted to the first stage of sale.

The narrowness of the tax base has accentuated the distortionary effects of the Indian tax structure. The effects have been largely ignored because of the preoccupation with raising more and more revenue. Given that the tax bases are narrow, requirements of revenue have necessitated high average tax rates for both direct and indirect taxes. Additionally, the emphasis on equity had led to virtually confiscatory levels of marginal tax rates in the case of personal income tax, though these have been moderated recently. The disincentive effects of such high marginal rates on work effort and investment were ignored.

In the case of indirect taxes, raising tax revenue at administratively convenient points has resulted in the imposition of a levy on inputs, outputs and capital goods alike at Central, State and even local levels, causing additional distortions in the tax structure. Similarly, high average rates of customs tariffs, combined with a large dispersion, have distorted the production structure. At the State level, tax competition to maximise revenues, generous schemes of sales tax incentives for promoting industrialisation and inter-State tax exportation have been a further source of distortions. Finally, attempts by the Central government to raise revenues from non-sharable sources like import duties and administered price increases have altered relative prices in unintended ways.

The tax structure in India has also become unduly complicated. A major reason for this is the pursuit of numerous objectives, apart from raising revenue, through the instrument of tax policy. Thus, equity considerations have led to minute rate differentiation in both direct and indirect tax structures, based merely on the policy makers' perception of what size composition of income or consumption is desirable. The same instruments were also used to encourage savings, promote investment, particularly in 'desired' industries (through differentiated investment allowance), maximise employment (through concessions to the small scale sector), promote inter-regional equity (through differentiated tax concessions across regions) and promote several other social objectives. Not surprisingly, the resultant tax structure has turned out to be a formidable maze.

At the same time, it is doubtful whether this complicated tax structure has really served to promote the intended objectives. With less than one per cent of population paying personal income tax, the use of this instrument to promote equity is not very meaningful. In fact, international experience shows that active public expenditure policies aimed at raising the consumption of the poor are far more effective in promoting equity as compared to tax policies aimed at containing the incomes of the rich (Gillis, 1989). Studies have also cast doubts on the effectiveness of tax concessions in enhancing the level of savings, while the inappropriateness of tax policy as an instrument for promoting employment, balanced regional development and a wide variety of other social objectives is well known (Das-Gupta, 1989 and Bagchi and Nayak, 1990).

Many of these problems have been recognised by the Tax Reform Committee (TRC) which has recently submitted its interim report (Government of India, 1991). Lessons from tax reform experiences in various countries indicate that complex systems suggested in the optimal tax literature are impractical (Musgrave, 1987). The most successful tax reform experiences are those which have concentrated on broadening the tax base, levying lower and less differentiated tax rates, simplifying the tax structure, exempting the taxes on inputs and strengthening tax administration and enforcement. These elements also characterise the philosophy underlying the interim report of the TRC.

In this report, raising revenue is taken to be the main objective of direct and indirect taxes. Bringing various perquisites into the tax net, rationalisation of tax incentives for savings, clubbing of non-wage incomes of the minor with parents' are some of direct tax measures aimed at this objective. In the case of domestic indirect taxes also, the emphasis of the report is on expanding the tax base by bringing important services into the tax net and extending the tax to the wholesale stage. In the case of import duty, however, the TRC has suggested that this be viewed primarily as an instrument for protection rather than raising revenue.

The TRC has also made recommendations regarding a gradual reduction in the rates of direct and indirect taxes, revenue sharing between the Centre and the States, tax harmonisation and other measures for simplifying the tax system, which will have to be phased in over a period of time. However, given the complexity and inefficiency of the existing tax system, the recommendation of the TRC should only be viewed as a beginning of the tax reform process in India.

4. Subsidies, User Charges and Non-tax Revenue

The tax reform measures discussed above are aimed at simplifying and rationalising the tax system, not necessarily raising additional resources. However, an altogether different kind of rationalisation is required in the pricing of public services, which could lead to considerable additional flow of revenue.

There is a large class of publicly provided services which are in the nature of pure public goods. Defence, general administration and the maintenance of law and order are obvious examples. Such services, characterised by non-rivalry and non-excludability in consumption, cannot be easily priced or `sold´ to individual consumers (Samuelson, 1954 and 1955). They, therefore, have to be financed out of general revenues. All other publicly provided services could, in principle, be priced so as to recover the cost of delivering such services. However, whether such user cost pricing is desirable or not is quite another matter. There may be large externalities in the consumption of some of these goods and services. In such cases the privately optimal level of consumption may be socially sub-optimal. The government may therefore decide to introduce a subsidy in order to support the socially optimal level of consumption. Again, there may be cases where the consumption of a `merit good´ like, say, primary education by the poor is considered essential or socially desirable. The government may deliberately subsidise the consumption of such goods and services for certain target groups[9].

Except in the case of such `merit goods´, `public goods´ and goods or services with large externalities, it would be desirable for the government to charge `user fees´ sufficient to recover cost. It turns out, however, that the recovery rates are not only remarkably low across the board but even declining over time. As a consequence there is a huge volume of subsidies involved in the delivery of virtually all goods and services being provided by the government. These include, of course, the explicit subsidies on food, fertiliser or exports already discussed above in the context of expenditure control. There is also the much larger flow of implicit subsidies by way of unrecovered cost in a whole range of social and economic services. If these services were properly priced so as to recover costs, except where the subsidies are deliberately introduced to support particular target groups, this would very substantially augment the total flow of non-tax revenues.

Our estimates show that between 1977-78 and 1987-88 the total volume of government subsidies including implicit subsidies rose from about Rs. 8,000 crore to over Rs. 44,000 crore, i.e., from 8.2 per cent of GDP to over 15 per cent. In economic services the average recovery rate declined from about 55 per cent of cost in 1977-78 to below 41 per cent in 1987-88, implying an increase in the total subsidy on economic services from about Rs. 4,500 crore to over Rs. 27,500 crore over the decade (Table 4). The lowest rate of recovery is seen in industry, where there was a steep decline in the recovery rate from just under 40 per cent in 1977-78 to less than 17 per cent in 1987-88. The recovery rate in agriculture and irrigation is not much better at around 20 per cent. In power only about a third of the cost is recovered while in communications, which was generating a 14 per cent recovery over cost in 1977-78, over 30 per cent of the cost now remains unrecovered. Transportation is the only sector where cost recovery actually improved over the decade. But even here, as much as 25 per cent of the cost still remains unrecovered.

TABLE 4

Subsidies in Social and Economic Services : States and Centre

	Recovery rate		Subsidies		Subsidy as percentage of total subsidy	
	1977-78	1987-88	1977-78	1987-88	1977-78	1987-88
	(Per cent)		(Rs. crore)			
Economic Services						
1. Agriculture and allied activities	35.93	20.49	1259	7117	15.97	16.02
2. Irrigation and flood control	25.77	20.27	973	4815	12.34	10.84
3. Power and energy	45.77	32.29	372	3619	4.72	8.15
4. Industry	39.11	16.81	636	5735	8.07	12.91
5. Transport	69.55	74.30	1101	3361	13.96	7.57
6. Communication	114.85	68.58	-90	1131	-1.14	2.55
7. Other economic services	64.94	31.43	235	1780	2.98	4.01
8. Total economic services	54.69	40.74	4487	27557	56.90	62.03
Social Services						
1. Education	2.75	1.30	2054	9585	26.04	21.58
2. Health	5.33	3.07	684	2937	8.67	6.61
3. Water supply and sanitation and housing	14.39	5.82	369	2430	4.68	5.47
4. Other social services	18.93	12.15	292	1916	3.70	4.31
5. Total social services	6.26	3.62	3399	16868	43.10	37.97

Note: Includes data for 14 major States and Centre.

Since many of these economic services are delivered by departmental or non-departmental government enterprises and cooperatives, it is not surprising that a large part of the subsidy in economic services actually flows in the form of budgetary support to offset the poor cost recovery of these public enterprises. Out of a total subsidy of about Rs. 28,000 crore on economic services in 1987-88, around Rs. 15,000 crore flowed through the public enterprises. Of this, about Rs. 9,000 crore flowed through Central public enterprises with an average recovery rate of only 41 per cent. In terms of their institutional classification, departmental enterprises had an average recovery rate of 67 per cent as against 31 per cent for non-departmental enterprises and only 20 per cent for cooperatives.

In other words, far from contributing a net surplus to the revenues of the government, public enterprises have constituted a major source of resource drain. In the context of the present fiscal crisis, this calls for urgent reforms in this area. Ways must be found of imposing a hard budget constraint on these enterprises in order to at least stop the drain of government resources, even if large surpluses are not immediately forthcoming. That in itself would release thousands of crores in financial resources. A part of the resources so released could be deployed to augment the quantity of some subsidised services, or improve their quality, where such subsidised services are desirable. The rest would significantly reduce the size of the deficit.

Turning to social services, the required course of action is less obvious. Recovery rates are much lower here, amounting to less than 4 per cent of the cost an average. In other words social services are being delivered virtually free of cost. Also, these services are being delivered largely through the State governments. Hence, the large bulk of subsidy on social services, estimated at close to Rs. 17,000 crore in 1987-88, flows through the State governments. This is in addition to the States' share of subsidies in economic services, which added up to about Rs. 13,000 crore in 1987-88, thus leaving the States with a total subsidy burden of about Rs. 30,000 crore in that year alone.

Clearly, the States cannot continue to subsidise public services on such a vast scale, given that their financial situation is even more stringent than that of the Centre (see section 5 below). On the other hand social services like education and health are precisely the services which ought to be subsidised on equity or 'merit good' considerations. Hence, the pruning of subsidies here will have to be very carefully calibrated in order to ensure that budgetary pressures do not subvert these larger social objectives. What can be said quite categorically, however, is that there is need for much closer targeting of subsidies in social services. This would help to filter out unnecessary or unintended subsidies. The resources saved through such improved cost recovery could then be deployed to actually raise the level of subsidy to deserving target groups, while reducing the total volume of subsidy at the same time.

A good illustration of this is the education sector. The total subsidy to this sector in 1987-88 was almost Rs. 9,600 crore. However, the subsidy to primary education amounted to only around Rs. 4,200 crore, the balance going to secondary and higher levels of education. In a country with around 60 per cent of the population still illiterate, any one who has reached a secondary level of education is already a privileged person. To subsidise persons at that level, indeed at a much higher per student rate than at the primary level, is clearly iniquitous. The argument that higher levels of education must be subsidised because of externalities is also not sustainable since the private returns to education are very high in some lines of specialisation and there is already a large surplus of manpower in others. Introduction of proper user charges could raise, at a conservative estimate, over Rs. 5,000 crore annually from this sector alone.

5. A Review of State Finances in India

This review of fiscal policy would remain incomplete if it did not address some of the critical issues pertaining to States' finances. The Constitution assigns the responsibility of providing major social and economic services to the States, they incur almost 60 per cent of total spending and raise 35 per cent of the revenues. The revenue deficit attributable to budgetary operations of the States constitute over one per cent of GDP while the fiscal deficit on States' account is about 3.5 per cent of GDP.

In some respects, the fiscal condition of the States is even more critical than that of the Centre. As in the case of the Centre, their expenditure is more income elastic than revenue receipts, thereby generating a built in tendency towards deficits. However, they do not have the same ability to finance their deficits. The States do not have independent powers to borrow from the market, nor can they take recourse to borrowing from the central bank because of the overdraft regulation scheme[10]. Given these constraints on debt financing for bridging the gap between expenditure and revenue at the State level, the burden of adjustment has tended to fall on capital and maintenance expenditure with rather serious long term implications for growth. Moreover, the squeeze on capital expenditure has been sharper in the less developed States, thereby aggravating inter-regional growth imbalances.

The trends in expenditure classified into economic and functional categories show quite clearly that the different elements of current expenditure have grown much faster than overall expenditure (Rao and Tulasidhar, 1991). While aggregate expenditure has grown at about 7 per cent in real terms during the eighties, items like interest payments and visible subsidies have been growing at close to 13 per cent. Other current account items such as transfer payments and compensation to employees have also grown at a relatively high rate of around 8 per cent[11]. Interestingly, the only item of current expenditure which has grown relatively slowly is that on goods and services, which are largely spent on the maintenance of capital assets. The significance of this is discussed further below.

The rapid growth of revenue expenditure has outstripped even the growth of tax revenues and Central transfers, which have themselves grown at a high rate of over 16 per cent per annum in nominal terms. Meanwhile the growth of non-tax revenues has been sluggish as a consequence of poor cost recoveries from various public services provided by the States. As a consequence of both uneconomic pricing as well as low efficiency of departmental and non-departmental enterprises, most of them have been reporting substantial losses. In irrigation, total losses including depreciation in 1987-88 amounted to Rs 5200 crore. As regards non-departmental enterprises, the several 'promotional' corporations, which seem to serve no purpose other than providing political patronage, claimed a budgetary support of over Rs 500 crore in the 14 major States. The two major non-departmental commercial enterprises, the State Electricity Boards (SEBs) and State Road Transport Corporations (SRTCs) have continued to drain States' exchequers. The average loss of SEB's was 14.4 per cent and that of SRTC's 12 per cent of the capital invested in 1990-91.

Given the poor flow of non-tax revenues, the growth of total revenue has failed to keep pace with revenue expenditure. It has also been pointed out above that, unlike in the case of the Centre, the expenditure-revenue gap could not be easily financed through borrowing by the States. Therefore, the entire burden of adjustment of this imbalance between expenditure and its financing has fallen on capital and maintenance expenditure. Both capital expenditure as well as expenditure on the maintenance of capital assets, usually shown as spending on goods and services, have been growing at less than 5 per cent per annum in real terms, while total expenditure increased at over 7 per cent. Consequently, the share of capital expenditure in total State government expenditure declined fairly sharply from 35 per cent in 1980-81 to 28 per cent in 1987-88. The situation is likely to further worsen in the next few years with the significant deceleration in Central transfers to States as a part of country's fiscal adjustment programme[12]. The long-term growth implications of the slow growth of capital stock in the State government sector and its poor maintenance are quite obvious. These have been compounded by efficiency losses due to various distortions in relative prices introduced by the structure of sales tax, inter-State competition in terms of this tax and tax exportation.

What is especially disturbing is that the squeeze on capital and maintenance expenditure has been much sharper in the less developed States (Rao, 1992). The growth of capital expenditure in these States has been significantly lower than that of high income States. The ratio of maintenance expenditure vis-a-vis compensation of employees has also been lower in the poorer States. This has considerably aggravated inter-regional growth disparities. The poorer States have also suffered on account of inter-State exportation of taxes from the consuming to the producing States on account of the Central Sales Tax. This should be obvious since production is concentrated in more developed States.

A similar inter-State disparity is also noticed in the distribution of social expenditures such as health and education (Rao and Mundle, 1991). Thus, in their various dimensions, State finances have tended to reinforce rather than reduce inter-regional disparities. This could have been avoided if the Central transfers were designed to offset the inherent fiscal disadvantages of the poorer States. Unfortunately, both statutory and plan transfers are given mainly on the basis of general economic indicators, with a dominant weight being assigned to population rather than fiscal disadvantage (Rao and Aggarwal, 1991).

It follows from the foregoing review of States' finances that reform in this area should focus on compression of current expenditure, rationalisation of the tax system and better targetting of implicit subsidies. Furthermore, Central transfers should henceforth be explicitly directed at offsetting fiscal disadvantages of the poorer States. Hopefully, this issue will be addressed by the Tenth Finance Commission. So far as the States themselves are concerned, specific measures which they could introduce have been discussed in some detail elsewhere (Rao, 1992) and are briefly listed below:

i) A freeze on fresh recruitment over the next few years, identification of surplus staff and their redeployment in order to moderate the growth of the wages and salaries bill.

ii) A cut-back on perquisites like leave travel concession, bonus and leave encashment would also help to decelerate the growth of staff related expenditure.

iii) Expenditure on redistributive activities such as elementary education, basic health facilities and poverty alleviation should be enhanced. The Centre should also suitably rationalise the Centrally Sponsored Schemes to facilitate enhancement of expenditure on such items.

iv) A part of the enhanced social expenditure should be financed through higher cost recoveries from services like irrigation, supply of electricity, road transport and post-primary education.

v) The major reforms on the taxes side relate to the sales tax. The base should be broadened by including value addition at the post manufacturing stages. However, taxation of inputs should be avoided. The number of rate categories should also be reduced and the tax structure should be simplified and the practice of using sales tax concession for industrialisation should be avoided. Measures are also needed to avert excessive tax competition among the States and to reduce taxation of inter-State sale.

A Final Remark

The foregoing review is necessarily selective. It has dealt with only some of the mere urgent issues in fiscal policy, such as the deficit, expenditure control, reform of the tax system, subsidies and user charges. Some institutional questions, particularly relating to States' finances and Centre-State financial relations have also been addressed. But fiscal policy is more than the mere arithmetic of budgets or even the formal processes of financial management in government. It is, in the main, an outcome of a political process. Such questions about the political economy of fiscal policy have not been dealt with in this paper as they have been addressed elsewhere in this volume (Bardhan, 1992). But it has to be said in conclusion that to lose sight of the underlying political power relations which drive fiscal policy is to miss the central point about the roots of India's current fiscal crisis.

Notes

1. The financial implementation of this strategy, along with reduction of inter-personal and inter-regional disparities, have constituted the basic goals of fiscal policy in post-colonial India. Apropos the literature on assignment of instruments to targets, it is important to ask whether even in principle fiscal policy could simultaneously meet all these goals (Tinbergen, 1952). However, the present paper is confined to the record of actual performance.

2. For a detailed analysis of savings and investment behaviour of different institutional sectors see A. Bagchi and P. Nayak (1990).

3. See Economic Survey, Government of India, Ministry of Finance, 1991-92.

4. See in particular Buiter and Patel (1990); Genberg (1989); Rangarajan, Basu and Jadhav (1990). For a more up-to-date analysis of India's debt problem and measures required to deal with it see the paper by Chelliah (1992) in this volume.

5. This thesis was developed in greater detail in Mundle (1990), where it was argued that the then prevailing high growth would not be sustainable.

6. See, however, the early work of Reddy (1972), Premchand (1963) and Toye (1981) among others. For work done during the more recent period see Sarma and Tulasidhar (1984), Mundle (1988) and Rao and Tulasidhar (1991).

7. See Mundle and Mukhopadhyay (1991). Excerpts of this paper were published in Economic Times, 20th January, 1992. See also the paper by Chelliah (1992) in this volume.

8. "Distributional coalitions" is taken to mean a narrow special interest group having disproportionate organisational power for collective action. (Olson, 1982).

9. For a more detailed discussion of these issues and an earlier estimate of subsidies in India see Mundle and Rao (1991). The earlier estimates have now been revised and are being reported here for the first time

10. According to the scheme, the Reserve Bank of India would not be obliged to honour the cheques of the States having overdrafts beyond seven continuous working days.

11. The above growth rates relate to the period upto 1987-88. Compensation in later years as a consequence of the salary revision subsequent to the Fourth Central Pay Commission report. The revision is estimated to have increased the salary bill by 18 per cent.

12. The Central transfers to the States in 1991-92 increased by less than 7 per cent over the previous year in nominal terms and the estimated increase in 1992-93 is just over 8 per cent.

References

Bagchi, Amaresh and Nayak, P. B. (1990), `Public Finance and the Planning Process : The Indian Experience´, Paper presented at International Seminar in Public Economics, January, 11-13, New Delhi.

Bardhan, P. (1992), "A Political - Economy Perspective on Development". This volume.

Buiter, W.H. and Patel, V. R. (1992), `Debt, Deficits and Inflation : An Application to the Public Finance of India, Journal of Public Economics, Vol. 47, No. 2.

Chelliah, Raja J. (1992), Growth of Indian Public Debt. This Volume.

Das-Gupta, A. (1989), Personal Taxation and Private Financial Savings in India, National Institute of Public Finance and Policy, New Delhi.

Genberg, H. (1989), `Fiscal Policy, Debt, Growth and Inflation in a Long Run Perspective : An Analytical Framework with an Application to India´, World Bank, October 5.

Gillis, M. (ed.) (1989), Tax Reform in Developing Countries, Duke University Press, London.

Government of India (1991), Interim Report of the Tax Reforms Committee (Chairman: Raja J. Chelliah).

Hinrichs, H. H. (1966), A General Theory of Tax Structure Change During Economic Development, Harvard Law School International Tax Programme, Cambridge, Mass.

Minhas, B. S., Jain, L. R. and Tendulkar, S. D. (1991), `Declining Incidence of Poverty in the 1980s : Evidence Versus Artifacts´, Economic and Political Weekly, July 6-13.

Mundle, Sudipto (1988), Pattern of Public Expenditure in India : A Financial Perspective of the Development State, Paper Presented at a conference on `The State and International Linkages´, The Hague, October.

Mundle, Sudipto (1990), `Food, Finance and Foreign Trade : The Limits of High Growth in India´ (mimeo), Department of Economics, Cambridge University.

Mundle, Sudipto and Rao, M. Govinda (1991), 'Volume and Composition of Government Subsidies in India, 1987-88', Economic and Political Weekly, May 4.

Mundle, Sudipto and Mukhopadhyay, Hiranya (1991), 'A Note on Central Government Expenditures, (Mimeo), Paper presented to the Finance Minister, November, 1991, New Delhi (excerpts published in Economic Times), January 20, 1992.

Musgrave, R. A. (1987), "Tax Reform in Developing Countries" in Newbery, D. and Stern, N. (1987), (Eds.), "The Theory of Taxation for Developing Countries", The World Bank.

Olson, Mancur (1982), Rise and Decline of the Nations, Yale University Press, New Haven.

Premchand, A. (1963), Control of Public Expenditure in India : A Historical and Analytical Account of the Administrative Audit and Parliamentary Process, Allied Publisher, New Delhi.

Rangarajan, C., Basu, Anupam and Jadhav, Narendra (1990), 'Dynamics of Interaction Between Government Deficit and Domestic Debt in India', Paper Presented at International Seminar in Public Economics, January 11-13, New Delhi.

Rao, C. H. H. (1992), "Agriculture: Policy and Performance". This Volume.

Rao, M. Govinda (1992), Proposals for State Level : Budgetary Reforms, Economic and Political Weekly, February 1.

Rao, M. Govinda and Aggarwal, V. (1991), "Central Transfers to Offset Fiscal Disadvantages of the States", Indian Economic Review, Vol. XXVI, No. 1.

Rao, M. Govinda and Mundle, Sudipto, (1991), "An Analysis of Changes in State Government Subsidies: 1977-87", Paper presented at the World Bank-NIPFP Seminar on State Finances, April 19-20,.

Rao, M. Govinda and Tulasidhar, V.B., (1991), "Public Expenditure in India: Emerging Trends", NIPFP Working Paper No. 5/1991.

Reddy, K. N. (1972), Growth of Public Expenditure in India, 1872-1968, Sterling Publisher, New Delhi.

Samuelson, P. A. (1954), 'Pure Theory of Public Expenditure', Review of Economics and Statistics, November.

Samuelson, P.A. (1955), 'Diagrammatic Exposition of a Theory of Public Expenditures', Review of Economics and Statistics, November.

Sarma, Atul and Tulasidhar, V. B. (1984), Economic Impact of Government Expenditure : An Analysis in Input Output Framework, Concept Publishing Co.

Tinbergen, Jan (1952), 'On the Theory of Economic Policy', North-Holland, Amsterdam.

Toye, J. (1981), Public Expenditure and Indian Development Policy 1960-1970, Cambridge University Press, England.

NIPFP WORKING PAPER SERIES : 1991-92

Working Paper No.	Title	Author's Name
1/91	Do Rate Schedules Affect Sensitivity of Personal Income Tax? An Evidence from a Developing Country	Pawan K Aggarwal (January, 1991)
2/91	Effect of Domestic Government Debt on Private Consumption And Saving in India	S Gopalakrishnan (April, 1991)
3/91	Reforms in Indian Sales Tax System	Mahesh C Purohit (June, 1991)
4/91	Monitoring Budget Deficits with Time Series Models Some Observations	JVM Sarma (June, 1991)
5/91	Public Expenditure in India: Emerging Trends	M Govinda Rao V B Tulasidhar (June, 1991)
6/91	A New Global Measure of Tax Progressivity	Pawan K. Aggarwal (August, 1991)
7/91	A New Hybrid Measure of Tax Progressivity	Pawan K. Aggarwal (August, 1991)
8/91	Priorities in Resource Allocation for Health Care in India: A Basic Needs Approach	K.N. Reddy K.K. Tripathy (August, 1991)
9/91	Domestic Market Structure And Exports in a Developing Country	Murali Patibandla (October, 1991)
10/91	Tax Reform in Developing Countries Agenda for the 1990s	Amaresh Bagchi (November, 1991)
11/91	Foreign Collaborations, Foreign Direct Investment And Taxation of Foreign Companies in India : Some Policy Issues	Manoj Pant (December, 1991)

12/91	Protection, Growth And Competitiveness : A Study of the Indian Capital Goods Industry	Sudipto Mundle Hiranya Mukhopadhyay (December, 1991)
1/92	Containment of Food Subsidy in the Context of Revenue Deficit	K.N. Reddy V. Selvaraju (January, 1992)
2/92	Some Simple Economics of Eximscrips	Mihir Rakshit (February, 1992)
3/92	Horizontal Equity and Disequalising Intergovernmental Transfers: An Example	A. Das-Gupta (April, 1992)
4/92	Analysing Progressivity of Personal Income Taxes: A Case Study of India	Pawan K. Aggarwal (May, 1992)
5/92	Trade and Exchange Rate Policy with a Binding Foreign Exchange Constraint	Mihir Rakshit (July, 1992)
6/92	Causality Between Public Expenditure and GNP: The Indian Case Revisited	J.V.M. Sarma V.V. Bhanoji Rao (July, 1992)
7/92	Framework for Design of Management Information System for Tax Administration: A Case Study of Somalia	M.C. Purohit (September, 1992)
8/92	Deficit Financing, Indirect Taxation and Exchange Rate Adjustment: A Preliminary Exercise	Hiranya Mukhopadhyay (September, 1992)
9/92	A Note on Central Government Expenditure	Sudipto Mundle Hiranya Mukhopadhyay (September, 1992)
10/92	Fertility Differential, Population Growth and Fiscal Operations	Mahesh C. Purohit D.N. Rao (September, 1992)
11/92	Maternal Education, Female Labour Force Participation and Child Mortality: Evidence from Indian Census	V.B. Tulasidhar (September, 1992)

and actual performance, these objectives have been by and large satisfied. Thus, the investment rate rose from only 10 per cent of GDP in the early fifties to about 20 per cent by the mid-seventies, finally reaching a plateau at around 23 per cent during the eighties. The domestic savings rate also rose from around 10 per cent to 21 per cent over the same period, with external capital inflows usually accounting for less than 2 per cent of total investment. The public sector share of total investment also rose from less than a third in the early fifties to about one half during the eighties.

However, the public sector's own savings performance has been quite disappointing. Though public sector savings have been less than public investment throughout the planning period, this gap widened considerably during the eighties. The share of public sector in gross domestic savings declined from over 20 per cent at the beginning of the decade to only 8 per cent by 1989-90[2]. In plan financing, while the Sixth Plan (1980-81 to 1984-85) envisaged that over 46 per cent of the public sector plan outlay would be financed by own resources of the public sector, the actual contribution turned out to be only 37 per cent. Similarly, during the Seventh Plan (1985-86 to 1989-90) only 27 per cent of the public sector plan outlay was financed from own resources as against a target of over 41 per cent.

Savings performance has fallen short of expectations both for public enterprises as well as the government. In the case of public enterprises, 236 Central Government enterprises yielded a net profit of Rs. 2368 crore in 1990-91, implying a rate of return of only 2.3 per cent on Rs. 101,797 crore capital employed. Of this, only 69 crores came from all the non-oil public enterprises put together. The record of the State level