PUBLIC EXPENDITURE POLICY AND MANAGEMENT IN INDIA : A CONSIDERATION OF THE ISSUES

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I. Introduction

For about forty years of planned economic development in India (upto 1991-92), public expenditure was considered a superior good; it prevailed that more of it was better and that a rising proportion of the additional output of the economy should be spent according to the collective wisdom of the government. The near-crisis situation of 1991 was an eye-opener in this context; it focused attention on budgetary trends of the government as the proximate cause and it also brought up larger issues of the role of the government and the economic reforms. All these served to emphasise the need for an assessment of govenment expenditure afresh. But in 1991, there was the danger of swinging to the other extreme, i.e., cutting expenditures across the board, mainly due to the preoccupation with fiscal deficit. Most would agree that that danger is also past. In 1996, we can perhaps examine the issues relating to public expenditure more dispassionately than ever before. That is one objective of this paper. A second related objective is to survey selected cross-country experiences with control of general government[1] expenditure/debt and to point towards the optimum role of a national treasury.

Following this line, Section II attempts a critical analysis of the prevailing expenditure policy and control issues in India, without traversing the ground regarding the achievements of the 1990s liberalisation process, which are well known, and confining the discussion to the

[1] The phrase "general government" usually includes various levels -- central, state and local -- government. In this paper, central and state government levels are included.

main theme under consideration. Given the extent of the public debt burden, Section III presents a broad discussion of cross-country practices in general government expenditure and debt management, with a view towards future policy guidance. Section IV concludes.

II. Public Expenditure Issues in India

It is convenient to group the public expenditure issues into one of the five categories that relate to five important aspects of the topic at hand:

First, the macroeconomic questions relating to public expenditures and their sustainability; the issues here are often empirical and even the questions (certainly the answers) can vary from time to time.

The second set of issues has to do with the normative questions that often cross the boundaries of economics; these have to do with the appropriate size of the public expenditures, or, by implication, the role of the government.

The third set of issues relates to the priorities in public expenditure on different services or different groups of people. This obviously connects with the distributional issues.

The fourth set of issues involves the form of public expenditure. Given the priorities in terms of target groups or services, the production/provision of the relevant service can normally be made in different ways with different combinations of inputs; how, why, and which combinations are chosen would obviously be an important set of questions.

The fifth and final set of considerations relates to the mechanics of public expenditure control and the political economy questions. Institutional setup is an important ingredient in the determination of public expenditure; how exactly it works in a particular context forms the subject matter of a number of erudite enquiries across the world.

It hardly needs to be mentioned that even this quick cataloguing of issues clearly shows the futility of trying to cover all important issues relating to public expenditures, even in a superficial fashion, in a small survey paper like the present one. Instead, we outline below a sample of issues that have been raised in India. Not all of them have arisen in the context of public expenditures *per se*; research in the area of public expenditure in India has not been all encompassing.

Macro-economic issues

The major trends with respect to public expenditures are well known. The long term growth in public expenditures has been well above the growth of non-debt receipts both at the Centre and States in general. Between 1974-75 and 1990-91, per capita government expenditures in constant prices grew at about 6 per cent per annum, whereas per capita revenue receipts in constant prices grew at only 4.6 per cent per annum (Rao, Sen and Ghosh, 1995). Thus, the fiscal deficit of the country as a whole has the tendency of growing and there is a constant struggle to keep it within limits. An obvious outcome of these basic trends is the recourse to rising net borrowing - both domestic and foreign (and/or deficit financing). Table 1 provides the relevant figures.[2]

The rising domestic borrowing has had two effects on the growth prospects. [3] First, it has pushed up the rate of interest, making the cost of capital higher (Table 2). This, in turn, has meant that fewer investment projects at the margin are profitable, which reduces the demand for investment. On the supply side, the government demand for the investible surplus has tended to crowd out private demand; the rate of capital formation being lower in the government (Table 2), the level of investment in the economy should have suffered as a result. The growth implications of this scenario are obvious.

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2 Note, however, that Central government expenditure as a percentage of GDP has declined on average in the 1990s compared to the 1980s, while figures relating to the States have increased. At least at the level of the Central government, contrary to popular discussion, it seems to be the tax revenue to GDP ratio that needs redoubled attention, reflecting a decline by approximately 1 per cent of GDP during the 1990s.

3 See Economic Survey, 1996, for a discussion of the components of total -- internal and external -- government liabilities, which have now reached 67 per cent of GDP.

Table 1
Aggregate Budgetary Trends in India

Item	1974-75	1980-81	1990-91	1991-92	1992-93	1993-94	1994-95 (R.E.)
Per Capita (in Rs.)							
A. Total Expenditure @	249.07	532.93	1892.63	2114.63	2322.41	2534.34	2885.94
of which, States *	122.46	292.06	991.95	1157.71	1263.73	1353.74	1619.23
B. Revenue Receipts	183.89	348.66	1195.78	1432.22	1562.70	1630.54	1926.53
C. GAP (A-B)	65.18	184.27	696.87	682.41	759.69	903.80	959.41
D. Domestic Borrowings	23.39	91.20	460.53	409.72	461.95	674.00	404.28
E. External Borrowings	11.29	18.59	37.87	62.42	59.26	55.45	36.08
F. Overall Surplus/Deficit	-12.65	-51.97	-140.12	-84.60	-146.72	-140.01	-66.65
As percentage of GDP							
A. Total Expenditure @	20.19	26.01	28.97	28.70	28.14	31.39	30.87
of which, States *	9.93	14.26	15.18	15.71	15.31	16.77	17.32
B. Revenue Receipts	14.91	17.02	18.30	19.44	18.94	20.20	20.60
C. GAP (A-B)	5.29	8.99	10.67	9.26	9.21	0.00	10.26
D. Domestic Borrowings	1.90	4.45	7.05	5.56	5.60	8.35	4.32
E. External Borrowings	0.92	0.91	0.58	0.85	0.72	0.69	0.39
F. Overall Surplus/Deficit	-1.03	-2.54	-2.14	-1.15	-1.78	-1.73	-0.71

@ Excludes intergovernmental transactions.
* Includes Intergovernmental transanctions.

Source: *Indian Public Finance Statistics* and *Economic Survey*, various issues.

Foreign debt gives rise to a different set of problems. Since a good part of the foreign debt is volatile in nature (the NRI deposits as a ratio of total net capital flows, for example, fluctuated between 11 per cent in 1980-81, 6 per cent in 1991-92 and 47 per cent in 1992-93), the capital flows exaggerate the cyclical fluctuations. The long-term implications in the foreign exchange front are also clear. Unless the foreign debt is invested in such a way as to result in adequate foreign exchange earnings, the servicing of these loans can put pressure on the exchange front. Although exports have been exhibiting reasonable rates of growth, they have so far been insufficient to cover imports, let alone foreign debt servicing obligations. The best performance in recent years was in 1993-94, when the exports covered almost 95 per cent of the imports.

Table 2
Cost of Capital and Rate of Capital Formation in India

Year	Prime Lending Rate of IFCI	Rate of Gross Capital Formation (Aggregate)	Rate of Gross Capital Formation (Public Sector)
1970-71	9	17.10	6.51
1975-76	12	20.83	9.63
1980-81	14	20.92	8.65
1985-86	14	24.19	11.22
1990-91	14-15	25.66	9.74
1991-92	18-20	22.87	9.17
1992-93	17-19	23.30	8.87
1993-94	17-19	21.35	8.58

Source: *Report on Currency and Finance* (various issues), Reserve Bank of India and *National Income Statistics*, Central Statistical Organisation.

The rising debt-service burden has resulted in preoccupations regarding financial costs; the rising proportion of interest liability in total government expenditure (from 8.06 per cent in 1975-76 to 21.3 per cent in 1995-96) has prompted fears of the entire revenue receipts being used up to pay interest on debt alone (see Table 3). The possibility of a 'debt trap' is a real one for some. Whether the situation is indeed so alarming or not is a moot point; what is certainly true is that the substantial interest burden without the utilisation of the debt in a way to raise sufficient returns for its servicing results either in raising the deficits further or cutting into the other categories of (possibly productive) public expenditure, or both (Shome, 1996).

Table 3
Debt Servicing Burden of the Government in India

Year	Interest Payments as % of Total Expenditure	Interest Payments as % of Revenue Receipts	Interest Payments and Repayment of Loans & Advances as % of Revenue Receipts	Interest Payments and Repayment of Loans & Advances as % of Net Borrowings
1975-76	8.06	10.80	19.38	76.29
1980-81	8.36	12.51	16.99	57.01
1984-85	10.28	16.09	21.50	71.78
1985-86	11.26	16.78	20.56	73.67
1986-87	11.56	17.99	21.71	69.52
1987-88	12.77	19.49	23.46	72.72
1988-89	14.16	21.32	25.30	69.91
1989-90	14.89	22.29	25.69	75.16
1990-91	16.12	25.00	28.63	86.91
1991-92	17.51	25.48	30.85	109.38
1992-93	18.07	26.49	30.16	112.60
1993-94	18.84	29.17	32.49	72.92
1994-95 (RE)	19.80	29.77	33.28	145.04
1995-96 (BE)	21.28	31.07	32.88	173.52

Note: All the figures are net of intergovernmental transactions.
Source: *Indian Public Finance Statistics.*

Another macroeconomic aspect of public expenditures relates to their inflationary impact. Public expenditures are affected by inflation, and in turn determine the rate of inflation. The quality of public expenditures is important in this context; if the overall fiscal policy is such that the net impact lowers productivity of the economy and capital formation, the stage is set for stagflation. Since the savings rate in the private sector in India is significantly higher than in the government sector, any redistribution of income to the government sector immediately reduces savings. Further, when, on the one hand, a large part of the expenditures are explicitly or implicitly transfer payments to groups with high marginal propensities to consume and, on the other, infrastructural bottlenecks resulting from relative neglect by the government exist on the production side, low growth and inflation might be expected. If prices are attempted to be controlled either directly, or indirectly through administered prices, the inflationary tendencies crop up in the uncontrolled markets (e.g., rents, professional consultation fees etc.) or in the black economy (real estate prices, professional incomes, etc.), causing tax evasion and a concomitant vicious circle of unfavourable effects (Tanzi and Shome, 1993).

Role of Government

In India, until recently, the role of government was considered central for most growth-generating economic activities. This role took a particular form. Controls, subsidies, production, procurement, distribution, provision -- various facets of governmental intervention pervaded different spheres of economic activity. This was a result of the basic philosophy of Central planning and public sector led development of the economy. Market failure in key areas of production, distribution and regulation, and a government continuously striving to enhance the welfare of the citizens were the major assumptions of this paradigm. The widespread government interventions gave rise to a huge public sector as well as a bureaucracy with increasing appetites for resources. More as a result of the emergence of a gigantic governmental apparatus than as a matter of rational policy, government expenditures kept rising as a proportion of the GDP until it reached 30 per cent in the second half of the 1980s and has hovered around that figure since then [the figure for 1994-95 (R.E.) is 30.1 per cent; see Table 1].

Since 1990-91, the expenditures of the Central government have fallen as a percentage of the GDP; but this fall has been countered to some extent by the rise in the States. One view is that the Centre has simply shifted the burden of some expenditures (like food subsidies) on to the States, which accounts for these recent trends. It has certainly cut down the plan loans (Sen, Rao and Ghosh, 1994); the grants recommended by the Tenth Finance Commission will also help the Centre to cut its own expenditures.

As a part of the economic reforms, the role of government has now been (and is being) reassessed. The possibility of "government failure", akin to the "market failure" argument, is now taken seriously. It is recognised that the government itself may have become too bulky and unwieldy. The public sector, for reasons that are well known, is generally considered to have become inefficient -- with only pockets of efficiency -- and a challenge to public resources. The establishment cost of government activity has risen and to provide the same or even a lower level of actual service, rising amounts of real resources seem to be needed to be spent. Yet, the large government expenditures have been faulted for being generally inefficient in providing the required service. This is now recognised both at the Central and the State levels. As a result, there is some attempt to withdraw from areas where the government does not enjoy a comparative advantage.

However, a clear picture of the role of government in coming years is yet to emerge, as there is still strong resistance to limiting the role of government to those areas where it works best and strangely, to increasing its role in areas like regulation and enforcement of property rights. The "distributive coalitions" that have wielded disproportionately large influence over expenditure decisions, and for their own benefit, now have an interest in the present level and distribution of public expenditures. It, therefore, might be expected that redefining the role of government, with the attendant implications for expenditure policy could now be viewed with some suspicion (Rao and Sen, 1993).

The consensus is, nevertheless, veering around to the view that in principle, the government should confine itself to the areas of public goods and possibly some merit goods. Technological changes have altered the status of natural monopolies and even pure public goods such as wireless broadcasting. On the other hand, the relatively recent focus on human development and environmental concerns do define a clear area of operation for the government. Regulation instead of production/provision of goods and services, provision of adequate and costed infrastructural facilities to private investors, and playing a promotional role with respect to socially desirable goals are other areas of legitimate government concern. Finally, the lessons learnt from the East Asian economies show that it is the quality of government intervention rather than the quantity that is important for economic growth (Tanzi and Shome, 1992). The 'how's and 'what's determine the success of the policy much more than 'how much'. If the government gets into production of alcoholic beverages, an area which is traditionally profit making, and spends the taxpayer resources on subsidising loss-making units in such areas, as for example, in Haryana and Orissa, this leads to questions regarding the rationale behind government's expenditure policy stance.

Table 4

Expenditure-Revenue Gap in India: Centre and States

(Rs. crore)

Item\Year	1990-91	1991-92	1992-93	1993-94	1994-95 (R.E.)	1995-96 (B.E.)
Centre						
A. Total Expenditure	100878	107903	122516	141690	156253	167081
B. Total Revenue	54990	66030	74116	75784	89439	101773
C. Gap (A-B)	45888	41873	48400	65906	66815	65308
States and UTs						
A. Total Expenditure	80232	95587	106149	120635	147339	163877
B. Total Revenue	62081	77165	86150	101025	118941	131836
C. Gap (A-B)	18151	18422	20000	19610	28399	32041
Aggregate (Centre, States and UTs)						
A. Total Expenditure	155141	176996	198490	225842	262602	286716
B. Total Revenue	98019	119878	133560	145302	175302	197266
C. Gap (A-B)	57123	57118	64929	80540	87300	89449
Total Fiscal Deficit (as % of GDP)	9.88	7.35	7.19	8.71	7.95	7.47

Notes: (a) Aggregate figures are net of intergovernmental transactions.

(b) Aggregate fiscal deficit refers to gross figures.

Source: *Indian Public Finance Statistics, 1995*, Ministry of Finance, Government of India.

Priorities

In the comprehensive Central planning framework, the emphasis was on bringing major aspects of the economy under government control and the resources spent to do it were not considered a binding constraint. This was almost equally true for the Central and the State governments. Even when the revenue receipts (capital receipts were essentially loans) were not sufficient to meet the revenue and capital expenditures on various functions and services, there was no serious attempt at prioritising expenditures and thereby economise (Table 4). Fiscal deficit of the aggregate government sector, therefore, stays above 7 per cent of the GDP. Borrowings and deficit financing continue to be taken as the balancing variables. The budget constraint should have been more effective at the State level, but it was not, partly reflecting a traditional role of the Centre as a lender of last resort and partly due to the ingenuity of the States in finding new sources of borrowing (see Bagchi and Sen, 1992 and Gopalakrishnan and Rangamannar, 1996).[4]

Despite the tendency for running deficits, however, there is no gainsaying the fact that certain services or functional categories did not get as much attention as they deserved while certain others received more than their due. An assertion like this always carries some amount of value judgement with it, but such expenditures seem not to have conformed even to the intentions of the policymakers. For example, in the case of expenditure on poverty eradication, while the tax structure is cluttered with distributional objectives and a preoccupation with progressivity (even though recently reduced), the much-publicised, targeted anti-poverty programmes [such as Integrated Rural Development Programme (IRDP) and National Rural Employment Programme (NREP) (later Jawahar Rozgar Yojana)] that comprise most of rural development programmes have tended to lack funds (Table 5), spread too thinly over too many beneficiaries and from many accounts, poorly administered. Expenditures targeted to specified weaker sections like Scheduled Castes and Scheduled Tribes were probably too little in comparison to the size of the target groups. Expenditures on farmers' subsidies on procurement of their surplus produce and on some farm inputs were, on the other hand, large and continuously rising even at the cost of significantly distorting

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4 This has also happened typically in middle-income, fiscally federal economies such as Argentina and Brazil. See Shome (1995).

allocation of resources and affecting distribution adversely. Practically free supply of power and water to the agricultural sector in many States and the large amount of fertiliser subsidy are cases in point. The last mentioned can at least be justified on the ground of encouraging fertiliser use, which is still low in India by international standards. But the same argument cannot be made in favour of the serious underpricing of scarce inputs such as power and water which would only encourage their overuse, if not misuse. [5]

Table 5
Share of Rural Development in Total Plan Expenditure

(Rs. crore)

(1) Year	(2) Plan Expenditure on Rural Development	(3) Total Plan Expenditure	(4) Col (2) as % of Col (3)
1980-81	1040.0	15023.4	6.92
1985-86	2226.1	33059.9	6.73
1990-91	4149.9	58369.3	7.11
1991-92	4141.6	64751.2	6.40
1992-93	5091.4	72852.4	6.99
1993-94	7033.3	88080.7	7.99
1994-95 (RE)	8270.1	106204.3	7.79
1995-96 (BE)	9922.7	128590.0	7.72

Note: Assuming the number of poor to be 30 crores, the per poor expenditure on anti-poverty scheme works out to less than Rs. 120 in 1990-91. This has, of course, more than doubled by 1995-96, but the amount is still too small to call for a wide coverage.

Source: *Indian Public Finance Statistics.*

A priority concern of the government, at least in terms of the share of aggregate expenditure, is education. This is clearly a vital area and there is no dispute regarding the

5 This appears to be a policy not consistent with other government agencies spending on advertising campaigns to save energy and water.

need to spend on education in general. But disaggregation beyond this point raises a number of controversies. An important question that is raised is: does the increased expenditure benefit the students in terms of greater availability of schools or better quality of education, or does it simply raise the quasi-rent that the government-employed teachers may be enjoying? Other issues within education relate to the share of primary and other levels of education. Finally, there are issues of leakage. For example, in particular States, college education is probably in excess supply going by the number of eligible school children completing secondary schooling. The same has been observed in the case of secondary schools. The only possible explanation of this anomaly is provided by the institutional arrangements; salary of teachers is paid by the government to the colleges run mostly by private organisations, teachers are usually selected by the management, and the market wage for teachers usually employed would be lower than the government scales prescribed. A combination of these factors allows the managements to choose their own candidates as teachers who actually receive only the market wage; the additional salary forms the profit in this business. Such leakages have been observed in Gujarat, Kerala, Orissa and West Bengal (see Ravishankar, 1989, for example).

Another important area stressed in recent years is health. In India, athough private expenditure probably outweighs public expenditure on health, the latter is extremely important in certain crucial sub-sectors like primary health care and public health. Due to the rising population, family welfare (or more precisely, family planning) has become the overriding concern and the primary health care institutions run by the government have almost become family planning centres. However, this is a self-defeating policy since it has been shown that infant mortality rate has a strong influence on the adoption of family planning methods. Good pre-natal care of women, proper medical attention at birth and cutting down on infant mortality would better help the cause of family planning. Primary health care system must work well as such to promote family planning; if that happens only information about family planning methods and necessary assistance for their use will be needed. The relatively large expenditure on persuasion and incentives should not then be necessary. In fact, this sector provides a good example of why coordination between various policies (not observed often in practice) is important. The connections between female education, child health, nutrition, water supply and sanitation, and family planning are already documented. There is clearly a need for an orchestrated public expenditure policy in these areas which, however, continue to be dealt with largely independently (Sen, 1993).

Table 6
Functional Classification of Government Expenditure

(Rs. crore)

Year	General Adminis-tration	Defence	Social Services	Economic Services	Loans and Advances	Total Expenditure
1974-75	1256.19	2130.64	3557.07	5491.32	2354.37	14789.59
1980-81	2718.36	3893.53	8474.26	15336.84	4956.42	35379.41
1985-86	5960.07	8560.10	20018.61	34594.78	7281.79	76415.35
1990-91	15647.53	15491.54	40434.51	71622.05	11945.84	155141.47
1991-92	18314.22	16450.86	44636.71	85621.96	11972.19	176995.94
1992-93	21744.30	17660.86	48923.61	98766.02	11394.80	198489.59
1993-94	24034.04	21939.28	58407.97	108174.98	13285.89	225842.16
1994-95 (RE)	28737.46	23596.72	72948.44	123128.15	14191.33	262602.10
1995-96 (BE)	34119.15	25634.00	79458.76	133580.75	13922.89	286715.55

Note: General Administration includes all interest payments.
Source: *Indian Public Finance Statistics.*

The broad functional distribution of government expenditure does not reveal any startling changes over the years except a spurt in expenditure on general administration -- mainly due to rising interest payments as noted above -- and a slowdown in defence expenditure (Table 6). These figures , however, do not reveal the low priority that economic services as a group have received in the revenue budgets of all levels of government, except for the major subsidies. The economic classification of the government budgets indicates that the assets already created under this category are not adequately maintained or kept in good repair (Rao and Tulasidhar, 1993). Since these are generally in the nature of infrastructural services, this has the result of reducing the general level of efficiency of the economy and raising the costs of production. The stagnant capital expenditures of the government have also hit this sector hard. Inadequate provision for this sector affects long-term growth prospects, as has been observed in the case of Kerala. The 'Kerala Model' emphasised human development which has resulted in the best human development index in India comparable to the advanced countries; but in the process, economic services were neglected and the effect is evident in the form of low growth of the State economy despite a large inflow of remittances. Privatisation could justify a deceleration, or even a cutback, in the public expenditure on economic services but, in reality, large scale privatisation is yet to take place, particularly at the State level where important infrastructural services such as irrigation, power and road transport are provided. Thus, inadequate provision for these services in the government budgets continues to imply, by and large, lower availability. Further, the fact that per capita expenditures in the States on this as well as other functions are directly related to the level of per capita SDP, does not augur well for the relatively less developed States (Gopalakrishnan and Rangamannar, 1996).

A worrying trend is the large share of total government expenditure claimed by wages and salaries. More than a quarter of the rising public expenditures has been claimed by compensation to employees, and their constant share from 1974-75 to date indicates a lack of scale economy. This is both due to rising employment and rising emoluments. The latter has been rising faster than the per capita income as well as the consumer price index. Thus, it appears that whatever economies of scale were actually available, were neutralised through a rise in emoluments. This has been much commented upon, so much so that now there seems to be a critical mass of consensus for reducing the number of employees, particularly at the lower levels, but paying the remaining employees well (a guide to what is 'paying well' is provided by looking at organised private sector emoluments for persons of equivalent rank). Comparisons of emoluments between the private sector and the public sector would raise a lot of dust and involve too many variables, but to make a dent on the problem of number of employees, the attrition policy must apply to all levels; the disguised unemployment is by no means confined to the lower echelons of the bureaucracy.

Two of the basic functions of government, national defence and maintenance of law and order, have not grown faster than the overall growth of government expenditures, despite pressures on the latter. However, an anomaly that may be pointed out is that within the category of maintenance of law and order, courts of justice have received a falling share of expenditure despite the complementarity with the other area of law and order, the police (Rao and Sen, 1993). Overall, the general administration has maintained its share in government expenditure over a long period, again reflecting the lack of scale economy. This is particularly surprising, because the tax administration costs have exhibited substantial economies of scale. Tax collection costs as a ratio of tax revenue shows a clear tendency of falling as tax revenue increases; this is supported by time series as well as cross-section evidence for the States (Rao and Sen, 1993).

Form of Expenditure

There are three important broad sets of issues in this category: tax expenditures as a substitute of other expenditures, capital versus revenue expenditures and plan versus non-plan expenditures.

The tax expenditure question, put in a nutshell, relates to the wisdom of granting tax concessions in preference to overt expenditures for the target group. This is resorted to extensively by the Centre as well as the States. It reduces the transparency of the system, apart from making the targeting less effective. The costs to the government are often unknown and escape the scrutiny of the control mechanism prescribed.

The relative neglect of capital expenditures has been well-documented and discussed by many. The expenditure trends clearly show a stagnant capital expenditure alongside fast rising revenue expenditure in India, despite the lack of adequate infrastructural facilities within the country. This problem is compounded by the fact that available resources are spread too thinly over too many projects, resulting in large backlogs and significant cost overruns. The burgeoning revenue expenditures have not only gobbled up all the revenue receipts, but also have cut into capital receipts as well and have thereby reduced the resource availability for capital expenditure. This creates an inherently unstable situation as the loan-servicing requirements make for self-propelling revenue expenditures with no compensating increase in the receipt flows. Given the trends in revenue receipts, keeping the revenue expenditures within the limits set by the revenue receipts is vital to generate resources for capital expenditure. This prudent policy seems to have turned turtle, and is clearly not sustainable. The issue of an efficient input combination (capital assets, consumables and other material, and personnel) for providing a service has been ignored in the process (Rao, Sen and Ghosh, 1995).

The primacy given to plan sizes and plan expenditures could be said to have been partly responsible for the present fiscal scenario. Essentially, plan sizes ought to depend on available resources for plan purposes (and the Central transfers available in the case of States). But due to very limited and even negative resources available for plan purposes from the revenue budget, and an unwillingness to compromise on plan size, plans have been financed with substantial amount of borrowings. The plans have changed their nature over the years to contain expenditures of current and capital nature in almost equal proportions from the original 30:70 ratio. As a result, the debts incurred for plan purposes have rarely been self-liquidating. It thus appears that to put a lid on the growth of expenditures, a rethinking about the whole planning procedure relating to its formulation and financing has become due.

This also relates to the issue that once approved by the Planning Commission, the expenditures incurred assume some kind of sanctity despite being unsustainable in the long run. The illusory difference between the plan and non-plan expenditures (expenditure on plan schemes started during a particular plan period become non-plan once that particular five-year plan is over) thus is partly responsible for continuously adding to schemes on which resources have to be spent. There is no inherent qualitative difference between a plan scheme and a non-plan scheme; there are several examples of large developmental projects (e.g., power projects in Karnataka) outside the plan. The time may be ripe to undertake a thorough review of the planning process - particularly its financing - and of the traditional distinction between plan and non-plan expenditures, which has generally prevented a holistic view of government finances. It may be opportune for the Resources Group for the Ninth Five Year Plan, which has already initiated its functions through the operation of Working Groups focussing on resources, savings, taxes and expenditures to look also into such matters.

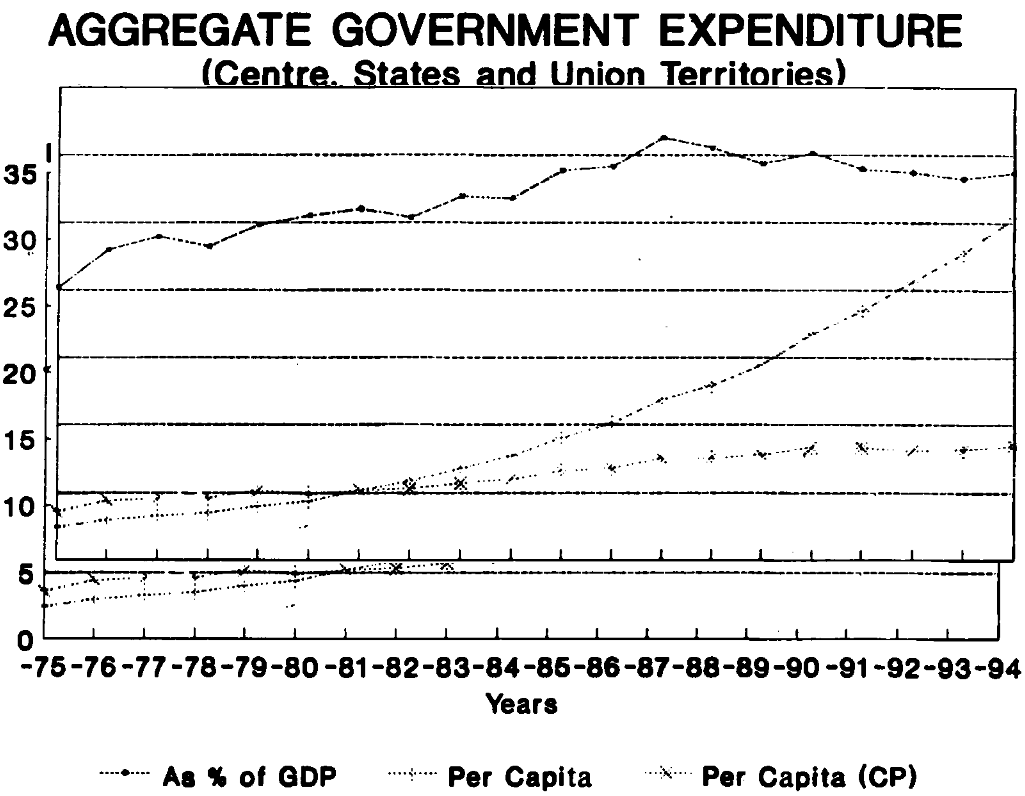
The formal distinction between current and capital expenditures, however, appears to be on a more stable foundation, despite the fact that the basic distinction of generating a future flow of returns from capital expenditure is, by and large, not in reality observed in India. But that does not rule out the presumption that certain expenditures are analogous to consumption in the sense that they are not expected to yield any returns and these current expenditures are different qualitatively from capital expenditures from which returns are expected. If the distinction was not maintained, there would be no way of judging the performance of the investments made by the government, as there would be no way of knowing what part of the expenditure was in the nature of investments.

Control Mechanism

There is a constitutionally ordained mechanism in place to maintain control over public expenditure. This consists of the office of the Comptroller and Auditor General and its subordinate offices, the legislature and the legislative committees, and the judiciary. The executive branch has its own control mechanism which includes bodies for scrutinising and approving proposed projects and for monitoring progress. Performance budget was introduced in 1975 and its scope was gradually expanded to monitor the effectiveness of government expenditures. Thus, there is an elaborate system of policy formulation, process control and efficiency control of public expenditure. Despite this system, the expenditures have grown much faster than revenue receipts, causing the fiscal deficit to grow. Obviously, this elaborate system tends to control expenditure in a mechanical or legal way; checks are made for the necessary approvals and completed forms: the contents of various expenditure proposals and their worth rarely gets a scrutiny once past the formulation stage. The system is not very successful in controlling leakages either; it has been stated that a non-negligible part of public expenditure ends up in the underground economy.

There are several indicators and symptoms of the system failure. Apart from the significant growth of public expenditures, the nature of the growth is instructive. A plot of the total public expenditure per capita at current prices exhibits such a smooth curve (Diagram I) that the hypothesis of budgeting through "creeping incrementalism" (in nominal terms) receives strong support *a priori*. Even in real terms, Diagram I shows that per capita government expenditure has increased steadily during the twenty years under consideration, more than doubling from Rs. 364 in 1974-75 to Rs. 845 in 1993-94. Since this is known to be the typical bureaucratic manner of budgeting, it also provides some evidence of the need for improvement in expenditure control. Possible areas include the fashion of preparation of some of the budget documents, the practices of the legislature with respect to budget discussions, the requirement for the executive to place audited accounts and audit reports before the legislature, and the obligation of the executive to respond to audit queries.

Diagram I



Note: Per Capita (CP) in '80-81 prices.

In the presence of strong budgetary constraints and limitations put by the macro-economic considerations, the expenditure budgeting must be ceiling-oriented or 'top-down' rather than the customary 'summing up' of the budgets from the lower level. The overall expenditure level needs to be fixed and allocated to different departments in consultation with the departmental heads. This process can be repeated downwards. Although the institutional setup within the executive exists to carry out this strategy successfully, the high proportion of committed expenditures like interest payments, wages and salaries and other contractual obligations in total expenditures can throw this process out of gear. To accommodate these, it may be necessary to adjust the ceilings somewhat, but such adjustments should be as far as possible at the departmental level itself. It may be useful to call for the budget estimates broken up by the committed and discretionary elements separately, given the ceiling. As a general rule of thumb, discretionary expenditures beyond the ceiling should not be allowed. Also, adequate guidance should be given regarding what constitutes committed expenditures.

The strategy outlined above can be successful only if the budgeted expenditures thus arrived at are not exceeded. The ongoing review process on the basis of monthly summaries prepared by the Chief Controllers of Accounts should be useful to ensure this. Further, supplementary grants need to be used very sparingly or the abovementioned budgeting process can be circumvented. A similar caution applies to the appropriations from the Contingency Fund.

In a framework of uneven and incomplete information flows, pressures of varying strength being applied on the executive to placate various "distributive coalitions", uncertain political awareness of the electorate and a short time horizon employed by politicians for various reasons, it is the policy level and the implementation level where control tends to become weak. A mechanical interpretation of the rules, deliberate or otherwise, often results in mere observation of the formalities without maintaining focus on the intent. There would need to be more follow up action to ensure that the resources spent for a particular purpose do translate into increased or improved delivery of the service concerned. Even performance budgets have not ensured this (Rao and Rajagopalan, 1993). The system is more target-oriented than goal-oriented; targets tend to be defined in a way that divorces them from the intended goal. Also, the expenditure itself is often the target; success or failure is measured in terms of resources spent, irrespective of the achievements in terms of the ultimate objective.

One of the reasons for the fiscal imbalance could actually be the absence of any prescribed link between receipts and expenditures. The budgetary system has little inbuilt checks on deficits. One way of introducing effective budgetary control would be to directly link expenditures to receipts where appropriate. An example is provided by earmarked taxes, e.g., profession tax revenue being used for Employment Guarantee Scheme in Maharashtra. Even though this is not a solution for all situations (for example, in Latin American countries such as Brazil and Costa Rica, too much earmarking seems to have led to much reduced flexibility), in India it might be considered given the exigency of the moment. Other possible examples could be financially self-sufficient hospitals, schools or universities. Non-departmental public enterprises should have provided examples of functioning self-sufficient units within the public sector, but by and large they have not been self-sufficient financially. Admittedly, this could be used only in a very limited way initially and could probably never be expanded very much. But it could provide useful lessons and give the proper signals. Another possible step would be to form legislative sub-committees to examine selected advance demands for grants each in detail, with the help of the representatives of the concerned departments. The final demands for grants could vary from the advance by a given margin. This would make up for the lack of scrutiny at the policy level that the "guillotine" rule causes. Such advance demands could be drawn up by the end of December every year.

A major dent on the rising government expenditures could be made, however, through a consistent policy of only necessary intervention by the government and firm control on government employment as well as wages. If left to the judgements of any prevailing set of decision-makers alone, however, political economy pressures would not expectably allow expenditure growth to be reined in. Perhaps we need a statutory limit on expenditure growth linked to receipts or to GDP, as have been introduced elsewhere. It would, however, be an extreme step to take, with the sacrifice of some fiscal flexibility.

III. Debt and Expenditure Management: Principles and Cross-Country Experiences [6]

India being a federal state, it would be pertinent to review fiscal federal arrangements in selected federal economies. This is so because, often in comparable federal countries, central governments have acted as spenders or lenders of last resort (Shome, 1995), which has important ramifications for government expenditure management policies.

6 See Premchand (1993) for a discussion on cross-country expenditure management at the national level.

Debt management: markets, co-operation, and rules-based approaches

Many countries are now redistributing tax and expenditure responsibilities to subnational governments. The 73rd and 74th Amendments to the Indian Constitution have embarked on a similar direction. Where public debt is concentrated in the central government, some control would be essential to see that decentralisation does not worsen fiscal performance of general government. Also, there should be no bail-out by upper level governments when lower level governments face a borrowing crunch. Of course, borrowers should have institutional structures, based on free and open market instruments, available to them. At the same time, there should be no obstacles on financial intermediation that places government in an advantageous position relative to the private sector (Ter-Minassian, 1995).

Many countries use control by the central government to check possible default by state governments. Thus, sole reliance on market discipline is rare among countries. Even in Canada, where municipalities have no constitutional limit to borrow, and borrow through subventions or municipal financial companies, market discipline is not fully effective. Indeed, provincial bonds comprise a poor market index. Nevertheless, provincial debt is increasing: perhaps there is a "recognition lag" in the market. In France, central controls were tightened recently to reduce regional level deficits, and a requirement for prior central approval was introduced. In India, approval of the Central government is needed by those States which have debt with the Central government. [7] However, to the extent that the Central government gives grants and loans at lower-than market rates of interest, Central control cannot be said to have imposed discipline at the State level.

Scandinavia uses a cooperative approach to the control of subnational debt. Limits are placed not by law or by the centre, but are arrived at through negotiations. Recently, in Australia, subnational governments have been participating in macro-fiscal objectives through targeting the deficit of general government. In Denmark, such negotiations are bilateral, while in Australia, they are multilateral, through a Loan Council in which all states and the centre are represented. Until 1993-94, the Loan Council determined the limit on the borrowing by

7 This restriction applies only to market borrowing and therefore not a binding constraint. Negotiated loans are often resorted to in order to avoid restrictions.

all states, including through any innovative off-budget techniques. To curb this, the Loan Council undertook ex-post monitoring to minimise them. The Loan Council also increased efforts to improve market discipline in borrowing through obtaining timely information on state finances.

Some methods comprise an attempt to use a rules-based approach using clear guidelines, transparency and even-handedness that should keep in check any bargaining between the centre and states, limits off-budget financing, and requires submission of timely data on revenue and on all phases of expenditure disbursement.

Rules are usually applied to limit such debt. Some countries prohibit or restrict borrowing of a particular kind that could lead to macro-economic problems, for example, central bank borrowing. Industrialised countries -- Germany, Switzerland, and some Spanish and U.S. states -- allow borrowing by subnational governments but stipulate repayment on an annual basis. In other countries, the centre sets more frequent limits on debts, reviews the operations, or attempts to centralise borrowing through, for example, on-lending to subnational borrowing for specific purposes such as investment. These methods are found in more unitary states such as the U.K., Japan and Korea.

Regarding the possibility of subnational governments borrowing externally, it should be recognised, first, that external debt policy is intrinsically linked to other macro-economic policies -- including monetary and exchange rate policy which comprise direct central government responsibility. Thus a co-ordinated approach to external debt is essential. Second, different market ratings for different states may exacerbate differentials in regional growth rates. Third, foreigners may, in any event, require the centre to guarantee loans to states at least implicitly. These matters are pertinent in India today especially as various committees and working groups discuss decentralisation of financing powers in the context of recent Constitutional amendments.

Expenditure management: role and functioning of a national treasury

The scope of treasury responsibilities should include the management of: (1) the cash flow of the central government, to guarantee a balance between revenue and expenditure and to be compliant to the release of resources for which the central government is responsible; (2) financial receivables (from state and local government and state-owned companies) and real estate property of government; (3) obligations and duties assumed by the central and state governments as well as state-owned companies involving external/internal credit; (4) the budgeting of central government subsidised credit for the financing of agriculture, exports, etc.; and (5) a coordinated system of public accounts. Selected other functions could be added (Portugal, 1995).

Ideally, the budgetary system should not be just an accounting system for revenues and expenditures. It should perform allocative, distributive and stabilization functions. It should allocate appropriately while excluding non-contributors. It should distribute according to factor earnings while redressing inequalities in income distribution. It should utilise fiscal policies to attain a position of balance in macro-economic indices such as employment, economic activity, etc.

Often, however, the only available instrument is the constraining of expenditures. The root of such difficulty is usually the unrealistic volume of the budget, related to the size of the state. The complications appear from various levels of government. There could be excessive rigidity in linking incomes to revenue, leading to overestimates of expenditures so that revenues are ensured for carrying out such expenditures, say on payroll. [8] Or between revenue and expenditure. Both, if not optimally managed, could lead to a reversal of priorities, resulting in the appearance of the question: what should be the role and the size of the state?

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8 For example, in Brazil, the 1988 Constitution increased expenditures on education as a ratio of total expenditures from 13 per cent to 18 per cent. Similarly, social assistance, social security and health care are also frozen in terms of overall expenditures. The execution of the central budget is undertaken within various such constraints.

If the accepted wisdom is followed, then the allocative function should be left to subnational government, the distributive function should be handled by the central government, while local government should undertake specific local functions. In India, many responsibilities, that should be, are not passed down. This might be changed if the recent Constitutional amendments are put into practice.

In general, actual expenditure management operations even in developing countries could be or may need to be fully mechanised. In the case of Brazil, which is a good example for India, links from various states to Brasilia (the capital) are computerised, through an "on-line, real-time control" mechanism. Banks collect revenues and transfer to a consolidated "single account" at the national treasury. On that basis, every month, the Secretary of the Treasury prepares a daily national forecast of revenue collection (for the next month).

After thus obtaining the amount of available resources, estimates of staff payroll (as determined by Presidential Decree), social security benefits, and servicing of external/internal debt are the first to be scheduled for financial payments. The next step is the allocation of revenues based on submission of demands from various bodies.

The execution of the budget also occurs through the "single account" system. Transactions among federal and subordinate institutions must be through accounts they maintain within the "single account". Only when payments are made to third parties is this account affected, which then affects the monetary base. Thus, the central bank also needs to know the details of the "single account" in order to manage its own cash flow. [9]

IV. Concluding Remarks

This paper attempted a *tour de force* of the major expenditure policy concerns as well as expenditure and debt management issues in India today. It also summarised selected

[9] The national treasury's focus is, however, mainly on the volume of transactions and not on their detailed composition. The only categories used are: payroll, internal service payments, external service payments, social expenditures and other. Within the last category, there are no restrictions on how a particular ministry should use these funds. There is no mention of specific expenditures, projects or payments.

principles and arrangements of expenditure management at different levels of governments, using illustrative cross-country examples. It pointed towards the major areas needing improvement in the case of India in light of the continuing high fiscal deficit to GDP ratio and its long run ramifications for public debt.

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