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MEASURES FOR COMPRESSING GOVERNMENT EXPENDITURE: OPTIONS AND IMPERATIVES

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Measures for Compressing Government Expenditure: Options and Imperatives*

Much has been said in recent days about the social costs of fiscal and structural adjustment and the need to distribute the costs equitably among the different sections of the society. This is an important aspect of the process of adjustment which must be of serious concern to the policy makers and the government. However, it would seem that the net costs of adjustment in the Indian case have been exaggerated by several commentators. The probable costs of adjustment have been visualised on an analogy with the experiences of heavily indebted countries such as Brazil and Mexico in the eighties. In their case, a large surplus in the current account of balance of payments had to be created for the repayment of external debt which of course meant a serious compression of domestic consumption and investment. Per contra, in our case, it is not one of the aims of the adjustment programme that the absolute level of our external debt be brought down; the aim is rather to convert short-term into longer-term debt and to ensure that the ratios of external debt to GDP and to exports would fall to sustainable levels. Hence there is no need to bring our domestic investment below domestic savings. Indeed if we succeed in attracting sufficient foreign investment, we may be able to maintain investment at a level higher than domestic savings.

In the Indian case, the costs of adjustment would be much lower than those borne by the people of Brazil and Mexico, but they would still be substantial. They would arise in two ways. Since equilibrium is to be restored in the balance of payments and in the budget, there has to be, in the short-run, curtailment of imports as well as compression of domestic demand. The attempt to eliminate excess demand in the economy through the reduction in the budget deficit and through stricter monetary policy tends to curtail real output growth as well as

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the rate of inflation. A similar adverse impact on growth arises from the compression of imports as well. This negative impact on growth can be offset by a faster growth in exports. Nevertheless, there would be a fall in the growth rate of GDP, particularly in the secondary and tertiary sectors.

Some economists have exaggerated the adverse effect on growth of the adjustment programme. Aggregative models linking the curtailment of demand to output and the fall in output to fall in employment could give misleading results. Besides, much depends on the discrimination in the curtailment of imports and the manner in which the excess demand emanating from the government sector is eliminated. For example, if the needed volume of imports of fertilizer, fertilizer inputs and diesel is ensured, agricultural growth will not be affected. This is of great importance as the great majority of the population and of the poor are dependent on agriculture and related activities, and agricultural prosperity is needed to generate and sustain growth in the other sectors of the economy. Similarly alternative patterns of pruning government expenditure will have differing degrees of impact on the rate of growth of output.

Thus through a careful policy mix, it is possible to reduce significantly the attendant costs of fiscal adjustment. Furthermore, the policy and institutional changes undertaken as part of the structural adjustment programme would lead to efficiency gains which in turn would have a favourable impact on real output growth. All in all, there need not be a drastic fall in the average rate of growth in the next two or three years. However, there would be gainers and losers. The poor should be spared any extra burden and everyone is agreed that there should be special programmes to prevent any further distress to the weakest sections of the society. But among the non-poor, those who were the beneficiaries of unjustified subsidies and sheltered inefficiencies will have to shed some past gains. That is the essence of adjustment.

The foregoing brief discussion of the nature of the costs of adjustment would serve to determine the manner in which excess demand should be eliminated through fiscal compression. In the short run, scaling down the fiscal deficit is primarily for demand management purposes. In the longer-term context, the reduction in deficit is needed to keep the growth of public debt within manageable limits. This latter objective should also be kept in view in deciding upon the ways and extent of deficit reduction.

Theoretically, the ratio of fiscal deficit to GDP can be reduced either by increasing (the rate of growth of) revenues or by reducing (the rate of growth of) government expenditures. In the present Indian context, most of the reduction has to be achieved through the reduction in expenditure. This is so far two reasons: First, the tax to GDP ratio has already reached 18 per cent, taking the taxes levied by the Centre and the States - a level that may be considered fairly high given the low level of per capita income. It may not be desirable or feasible to plan for a buoyancy in tax revenues of more than 1.1 or so. Some economists have argued, and correctly, that more revenues in the form of direct taxes should be collected from the better off sections of society because now they are contributing much less than their due share. Indeed it is to be hoped that the government would re-structure the direct taxes and improve methods of enforcement so as to raise the yield of personal direct taxes. However, since there has to be a significant reduction in the level of import duties, total tax revenues cannot be expected to rise very fast. Second, there will be justification for relying more on tax receipts to reduce the fiscal deficit, if there is little waste in government expenditure and all expenditures are for essential purposes, which cannot be pruned without seriously affecting general welfare. In point of fact that is not the situation in India. According to the general perception, the government has over-extended itself, there is considerable over-staffing and a not inconsiderable part of government expenditure is accounted for by undue benefits and perquisites conferred on those in the government. It is difficult to persuade citizens to bear a higher burden of taxation for worthy purposes, unless the growth of government expenditure is drastically curtailed.

In what follows we indicate the major ways by which government expenditure at the Central level can be cut down or made to grow at a slower rate (as the case may be), keeping in view the provisos that the reductions must least affect growth and that they should result in the least burden on the poor.

Traditional methods of cutting expenditures through "economy measures" are geared to gaining a temporary reprieve. As the underlying long-term tendencies are not addressed, the crisis surfaces repeatedly. The measures which the government should implement now should not only have an immediate impact but also must be such as to bring down the longer-term rate of growth of expenditure. Analytically, three objectives can be distinguished: (a) the short-term objective of eliminating excess demand, (b) the medium-term objective of phasing out the revenue deficit, and (c) the long-term ~~of~~ objective of keeping the rate of growth of revenue expenditure below that of net revenues of the Centre and regulating the growth of total expenditure such that the debt/GDP ratio will stabilise at a reasonable level.

Public finance scholars decompose the fiscal deficit into primary deficit and interest payments by the government. The ratio of interest to GDP is around 4.5 per cent in the current year; in 1992-93, it is likely to be 4.6 per cent. The IMF prescription of bringing down the level of fiscal deficit to 5 per cent of GDP would imply that the primary deficit should be confined to 0.4 per cent of GDP. Since the revenue deficit is around 2.4 per cent of GDP, it can be taken that of the fiscal deficit of 5 per cent of GDP, 2.4 percentage points would be absorbed by interest payments leaving only resources amounting to 2.6 per cent of GDP for government capital formation and lending. This prescription may be considered too harsh. Tentative projections of the debt profile carried out at the NIPFP, on the assumption of an average nominal GDP growth rate of 13 per cent and on some other reasonable assumptions, indicate that (a) if the primary deficit is kept constant at 1.9 per cent of GDP from the year 1992-93 (giving a total deficit of 6.5 per cent of GDP in that year), the deficit to GDP ratio would continue to rise and reach 7 per cent by 2000-01 and so would the ratio of interest to GDP, reaching 5.1 per cent in the same year. The average rate of interest on debt also would keep rising, though the debt to GDP ratio is likely to fall slightly and (b) if the primary deficit is kept constant at 1.0 per cent of GDP from 1992-93, the ratio of deficit to GDP will gradually fall to 5.3 per cent of GDP by 2000-01 and the ratio of interest to GDP to 4.3 per cent. And the debt to GDP ratio would steadily decline.

While the first scenario is not acceptable because interest payments would continuously rise crowding out other expenditures, the second scenario represents a gradually improving debt and fiscal situation. Keeping aside the negotiations with the IMF on this matter, it would appear that the Central Government would have to take measures to ensure at least that the primary deficit does not exceed a level of around 1.0 per cent of GDP for many years. With this stipulation, the total fiscal deficit will be contained around 5.5 per cent. This underlies the imperative need to eliminate the revenue deficit within the next few years. With the present level of revenue deficit, the own capital formation of the government and its Plan loans to the States and other entities will have to be limited to around 3 per cent of GDP, if the fiscal deficit is not to exceed 5.5 or 5.4 per cent. In 1985-86, Central Government capital formation and loans amounted to nearly 7 per cent of GDP, and in subsequent years the ratio has been well above 5 per cent. Thus, cutting it down to 3 per cent of GDP would represent a severe cut in plan investment. Thus unless the revenue deficit is phased out soon, Plan investments in the government sector would be cut to the bone with a highly adverse impact on growth.

It is not, however, easy to eliminate the revenue deficit as quickly as it is necessary, unless a clear plan of action is formulated and the Finance Minister is prepared to adopt quite unorthodox methods. A simple exercise will show up the enormity of the problem. Let us make two alternative assumptions about the buoyancy of Central revenues: 1.14 (historic) and 1.24. Assume further that nominal GDP would grow at 13 per cent per annum (5 per cent real growth and 8 per cent inflation). Thus revenues would grow at 14.9 - 16.2 per cent depending upon whether the buoyancy of revenues corresponds to the lower or higher estimate. Given this order of growth of revenues, if the revenue deficit is to be phased out in three years, government's revenue expenditure should not grow faster than 8-9 per cent per annum, i.e., expenditure will have to remain virtually constant in real terms. This may be considered an impossible demand. If we then set the target of phasing out the revenue deficit in five years, then the growth of revenue expenditures would have to be contained between 11 and 12 per cent in nominal terms, depending upon the buoyancy of Central revenues. Note that even with the longer period of adjustment, revenue expenditures can grow only somewhat slower than nominal GDP. To keep the growth of expenditure down to even the higher level is not going to be an easy task. Hence my plea that an entirely new approach to the problem must be formulated.

In recent years, because of the operation of compound interest on growing debt, interest payments have been growing faster than the non-interest revenue expenditures. Hence, besides cutting the growth of the latter, the problem of growth of interest payments must be attacked directly by liquidating a sizeable portion of debt. In what follows concrete measures are spelt out for slashing the growth of revenue expenditure.

Contraction of government and reduction in government civilian employment

It is widely agreed that government has over-extended itself and that there is considerable over-staffing in government departments. Excess staffing automatically entails excess associated government consumption expenditure. It is to be noted that the civilian staff of the Central Government increased by one million during the last decade or so, and now number four million. Note further that between 1984 and 1991, the number of posts of secretary to the government increased from 61 to 131 and those of additional and joint secretaries from 258 to 758! The Finance Ministry's directive that every department should shed 10 per cent of its activities which are of the lowest priority is to be welcomed. However much more is required. There should also be a virtual freeze on recruitment for at least three years so that at least a good bit of the excess staff could be shed. It is estimated that the normal fall in staff strength in a year due to retirement, resignation, death, etc., is about three per cent of the existing staff. For three years recruitments should be limited to 0.5 per cent of the existing staff, leading to a fall in staff by 2.5 per cent every year. This would bring the staff strength down by about 7 per cent in three years, giving a saving in wages and other "consumption" expenditure costs to the extent of about Rs. 1800 crores with a reduction in staff of 2.8 lakhs. Employment of casual labour in place of the reduced staff strength should be prohibited.

The above measures are related to shedding some of the surplus staff (estimated to be on the average 20-25 per cent). Besides these measures, one has to think of ways of dealing with the "surplus" staff of those regulatory economic departments which have become redundant with the new economic policy involving deregulation, such DGTD, offices of the CCIE and Steel Controller and TDA. There has to be substantial reduction in staff also in departments/ministries like agriculture, irrigation, rural development, urban development and small industries, which deal with subjects which fall primarily in the States' jurisdiction. Since no retrenchment is contemplated, the surplus staff in these departments in excess of 2.5 per cent of staff strength have to be retained for the time being, but they should be re-deployed in some departments which need to be strengthened. Alternatively, in these departments, the policy of nil recruitment should be continued beyond three years and until the surplus has been fully shed.

Reduction in governments' consumption expenditure related to staff

(a) Given the dimensions of the economic crisis, some degree of austerity must be imposed on all sections of the population except the poorest. It is proposed that the facility of LTC be temporarily withdrawn for the next block of four years and the payment of "bonus" be suspended for two years.

(b) Physical limits should be set on the free use of telephones (number of calls), motor transport (number of litres of petrol) and electricity and water, in respect of all government personnel (including MPs) who enjoy these privilege except the cabinet ministers, the President and Vice President. Beyond the limits set, full or at least 75 per cent charges should be levied.

(c) It is suggested that transfers of government servants be suspended for three years. For important reasons of State policy a few exceptions not exceeding 100 in number could be authorised by the Cabinet.

If the policy of non-filling of vacancies as stipulated above is adopted, the saving in government's revenue expenditure in the third year will be around Rs.1800 crore. If all the other `austerity' measures are also taken, the total saving would be roughly Rs.2800 crore.

Reduction in subsidies

By 1990-91, subsidies were adding upto over Rs.10,000 crore. In the 1991-92 budget, the government has reduced the export subsidy by Rs.1400 crore. The first steps have also been taken to contain the fertilizer subsidy. The remaining export subsidy can be gradually phased out along with the phased reduction in the level of import duties and with further moves towards convertibility. As far as fertilizer subsidy is concerned, as Dr Sudipto Mundle has suggested, with the aim of phasing out the subsidy in the medium term in two or three stages, to begin with the amount of subsidy per tonne of fertilizer may be kept constant at the present level. Finally, since it is essential that the least burden of the cost of adjustment should be imposed on the poor, no attempt should be made to drastically prune the food subsidies. The degree of subsidisation - i.e., relative difference between the issue price and the cost to the FCI may be held constant and only cheaper varieties of grain may be released. But the PDS itself will have to be expanded to cover all the weaker sections in the country. All in all, it should be possible to permit the total of subsidies to grow only nominally, keeping its volume constant in real terms.

Defence expenditure

In considering possible containment of the growth of defence expenditure obviously the security interests of country must be given due regard and abundant caution is to be exercised. However, it is agreed on all hands that cost effectiveness of defence expenditure must be enhanced. It could be assumed that at least for the short-run defence expenditure on revenue account could be kept constant in real terms.

Capital assistance and subsidy to public enterprise

The government has already reduced substantially budgetary support to the plan investment by public enterprises. Further cuts are envisaged during the eighth plan period. Also, there are plans to cut down the subsidy to loss making public sector undertakings by gradually closing down or selling non-viable enterprises. Since both these steps would be undertaken as part of containing the overall fiscal deficit, which is in itself a policy parameter, there is no need to elaborate on these steps. However, it may be pointed out that the unviable enterprises need to be closed down only in small numbers in each year so that labour would be displaced only to a limited extent each year.

Liquidation of public debt for directly reducing interest payments

The net interest payments by the government can be reduced either by bringing down the gross interest payments or by increasing the income from government's investments. It does not seem feasible to increase the latter, given the low net rates of return earned by public enterprises and the concessional rates at which loans are given by the Central Government to the State governments. It is therefore necessary to find ways of reducing the gross interest payments by the government.

Although the measures suggested in the preceding five sections would result in a substantial reduction in governent revenue expenditure, that would by no means be sufficient to enable the government to phase out the revenue deficit within the next five years, particularly because one cannot rely on high revenue buoyancy[1]. The growth of interest payments would have to be slowed down considerably.

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1. During the medium term high revenue buoyancy cannot be expected because the rate of growth of revenues from import duties will fall and a substantial proportion of increases in revenue from personnel income tax and excise duties that may be brought about would accrue to the States.

The conclusion seems inescapable that certain measures have to be adopted to effect reduction in the existing stock of debt. Since it would not be possible or desirable to create a surplus on the current account of balance of payments in order to reduce external debt, debt reduction has to be confined to internal debt.

As at the end of 1990-91, the total internal debt of the Government of India amounted to about Rs.2,60,000 crore. Of this, Government's debt to RBI amounted to about Rs. 72,620 crore, forming nearly 28 per cent of the total internal debt. One view, shared by many economists, is that this liability of the Government of India to RBI is fictitious. According to this view the accounts of RBI should be integrated with those of Government of India. If this is done the debt to RBI would get cancelled and the total interest burden will be accordingly reduced. If there is no other change, the expenditure by RBI out of its profits attributable to the large interest payment (about Rs. 4,000 crore) received from the government would be shown as government expenditure. In fact, however, RBI has its own separate accounts and it is returning only a small portion of the total interest it earns from the government on a debt which comes into existence merely through credit creation. The rest of the "profits" are either lent to certain priority sectors, or are used to cover certain liabilities such as those arising from the assumption of exchange risk in respect of FCNR deficits, or absorbed by RBI for its own rather high establishment expenditure.

Since RBI is not borrowing to lend but creates credit for that purpose, most of the interest paid by the Government of India should be returned to it by way of dividend whereas RBI now pays a dividend of only Rs. 350 crore. There are priority sectors which require credit but it is not clear that RBI should be in the business of lending directly to different sectors of the economy. It is primarily a banker's bank. Nor is there any economic logic linking credit to particular sectors with the extent of government deficits financed by RBI. If it is now maintained that RBI will be in the red but for the Rs.4,000 crore of interest paid by the government, it would mean that RBI is kept solvent only by the "improvidence" of the government! It seems clear that the pattern of activities by RBI and the manner of financing those activities, etc., should be thoroughly reviewed. Even if at the moment RBI cannot be asked to return a substantial proportion of the interest which it is receiving from the government, it should be required to raise the dividend to at least Rs.1000 crore a year. This amount of dividend should be used to retire market debt owed by the government. It should be further stipulated that in future years at least 80 per cent of the total additional interest payments ~~by~~ to RBI ~~to~~ by the government should come back as additional dividend also to be used for retiring market debt.

The government confiscates contraband gold that has come in through smuggling. Now that our foreign exchange reserves have reached a reasonable level, all gold that is confiscated in future should be sold in auction to the public at a price not less than the ruling internal market price and the proceeds applied to the retirement of debt.

Third, the government has decided to disinvest only Rs. 2500 crore out of its total investment of Rs. 63,000 crore in Central public enterprises. In the next two years, government's equity in public enterprises worth Rs. 5,000 crore (at face value) should be sold to the public with the proper premium. The best course would be to list the shares in the stock market and to initially sell through brokers a small portion of the total to be disinvested, with due publicity regarding the performance of the enterprises concerned. As the market picks up, more of the shares can be sold. The entire amount realized (and it would be considerably more than the face value of Rs. 5,000 crores - something like Rs. 10,000 crore) should be applied to the purchase of market debt.

Finally, it is suggested that the government should sell a small part of the vast real estate it owns in the country. Sale of land to the extent of Rs. 10,000 crore could be considered. This amount again should be applied to the retirement of debt.

It must be emphasised that the sale of assets should be matched by an equivalent reduction in liabilities. The proceeds of the sale of assets should not be used to finance government expenditure, as in 1991-92.

All in all, the stock of internal debt existing at the end of 1991-92 could be brought down by about Rs. 25,000 crores in three years. That will lead to a saving in interest of Rs. 2,875 crore computed at 11.5 per cent interest. With this reduction and the containment of fiscal deficit at 5.5 or 5 per cent of GDP, the growth of interest payments will be considerably slowed down.

What is to be understood clearly is that without liquidation of a substantial part of the existing stock of internal debt, it would not be possible to eliminate the revenue deficit within even the next five years. And without that, the volume of government investment will have to be kept too low, affecting growth and welfare.

Concluding remarks

None of the measures suggested in this paper would cast any burden on the poor. Even the virtual freezing of employment in the government sector would not mean any hardship since none will be thrown out of employment and with larger funds being available in the private sector there will be scope for faster growth of productive employment. The shearing of the surplus of government staff means in effect reducing subsidy to unproductive workers, the burden of which will be lifted from the shoulders of the general taxpayers. The retirement of debt through the use of the proceeds from the sale of gold and of land would pump additional funds into the money and capital markets in a non-inflationary way and help finance a rising volume of investment, while the sale of part of the equity of public enterprises would broaden the base of the stock market operations. In fact, the link that is established between profitable public enterprises and the capital market would serve to induce them to be better performers so as to attract larger funds and also enable them to grow without seeking budgetary support from the Government. As has been argued by several writers on the subject, the government should both extend the public distribution system to cover a larger proportion of the weaker sections and expand the more effective poverty alleviation programmes. Apart from that, policies that stimulate private investment and exports would open up additional avenues for employment. Since construction on government account is likely to decline or not grow fast because of fiscal compression, it is necessary to take some steps to stimulate private construction. In this connection it is strongly recommended that the Urban Land Ceiling Act be withdrawn from class C and D cities and towns so that a boost will be given to private house construction activities, benefiting construction workers who might otherwise face a contracting market.

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