

Fiscal Imbalance and the Indian Economy: Implications for Growth

Sunil Kumar Sinha and Devendra Kumar Pant^{1,2}

The long held view that fiscal expansion are beneficial for stimulating economic activity/ growth has been a subject of long standing debate about both its theoretical standing and practical importance. However, 1990s saw the emergence of a view that contractionary fiscal policy, rather than having the often assumed contractionary short term impact on output could be expansionary. In this regard, the most noted examples are of Denmark and Ireland.

Thus during 1990s discussion of fiscal policy focussed mainly on fiscal deficit and government debt as a source of inflation, balance of payments problem and on the contribution of fiscal adjustment to stabilization programme designed to address such problems. However, with prolonged slump in Japan, Korea and Thailand during Asian crisis and more recently in the US and Europe emphasis once again has shifted to the role of fiscal policy in stimulating economic activity/ growth.

The case of India is no different. For reason which seemed obvious and persuasive in 1950s many developing countries including India, recognized from the very outset that, given the mixed character of the economy, fiscal policy would have to play a key role in ensuring macroeconomic stability and in turn act as a catalyst for sustained economic growth. The task set out for fiscal policy in the Indian context were principally to:

- i) help to finance investment by raising the level of domestic savings;
- ii) bring about a reduction in the inequalities of income and wealth; and
- iii) influence the volume and direction of economic activity.

As Bagchi and Stern (1994) noted "the early results of this policy were quite striking. Breaking out of the stagnation of the preceding fifty years Indian economy grew at about 4 per cent per annum in the first two plan periods. Per capita income grew at 1.8 to 2 per cent. But this momentum was not maintained. What was more, financing of public sector proved increasingly difficult, leading to larger and larger recourse to market borrowing and deficit financing (borrowing from the central bank) with all their attendant consequences. Before the decade of 1980s had drawn to a close it was evident that the government budgeting in India was in a crisis." Apparent reason for the imbalance in Indian public finances was non other than the faster growth of government expenditure than the revenues. Thus a fiscal correction was inevitable. Although the move towards fiscal adjustment in India was discernible in the pronouncements made as part of long term fiscal policy announced in the mid 80s, a comprehensive fiscal reforms programme at the Central Government level was initiated only at the beginning of the 90s as part of the economic adjustment programme initiated in 1991-92. The fiscal reforms were aimed to achieve a reduction in the size of fiscal deficit and debt in relation to GDP and was affected through rationalization of tax structure, expenditure pruning, restructuring of PSUs and better coordination between monetary and fiscal policies.

The fiscal performance during the post reforms period shows a clear divide in mid nineties in the attainment of fiscal targets. While the period of 1991-92 to 1996-97 (barring 1993-94) witnessed

¹ Fellows, National Council of Applied Economic Research, New Delhi. The initial version of this paper was presented at a workshop held at IIM Kolkatta in December 2004. We are grateful to Prof. Mihir Rakshit and all the participants of the workshop for their valuable comments. Authors alone are, however, responsible for any errors.

² This report was prepared by consultants for the Asian Development Bank. The views expressed in this report are the views of the authors and do not necessarily reflect the views or policies of the Asian Development Bank (ADB), or its Board of Governors, or the governments they represent. ADB does not guarantee the accuracy of the data included in this paper and accepts no responsibility for any consequence of their use.

some success in fiscal consolidation, the trend since then has been one of reversal in fiscal correction with some improvement again being witnessed since 2002-03 on all the key deficit indicators, viz., gross fiscal deficit (GFD), revenue deficit (RD) and primary deficit (PD). During 1990-91 to 1996-97 the reduction in total expenditure to GDP ratio of more than 3.5 percentage points narrowed the fiscal gap by 3 percentage points. However, the fiscal consolidation even during this period was mainly brought about by curtailment in capital expenditure. Decline in consumption expenditure was relatively small. This fiscal correction through reduction in capital expenditure is often cited as one of the causes for economic slowdown during second half of nineties. It is also argued that the great improvement in growth during 1980s as compared to 1970s owes a lot to high government expenditure particularly capital expenditure. In fact, it has been argued that it is not the fiscal deficit *per se* which is a problem, but the inappropriate government expenditure coupled with the mode of its financing is the problem. In this view, a substantial increase in government expenditure on investment, especially in agriculture and infrastructure is advocated through greater monetization of fiscal deficit (Patnaik, 2001; Rakshit 2000; and Shetty 2001). A somewhat moderate view though recognizes the importance of fiscal activism in promoting growth via public investment, it also stresses that fiscal deficit beyond a point is not sustainable, and therefore adjustment is inevitable (Mohan 2000; Bagchi 2001). Here while Bagchi (2001) advocates such an adjustment to be done at a higher level of public investment expenditure with curbs on inessential expenditure rather than focussing on expenditure compression across the board, Mohan (2000) stresses the need to relate expenditure to user charges on all public services amenable to such charges. A more orthodox view questions the usefulness of expansionary fiscal policy at the current juncture and argues for further fiscal consolidation (Lahiri & Kannan 2002; Acharya 2001). Even the Report of the Prime Minister's Economic Advisory Council (EAC, 2001) says that high fiscal deficit by raising real rate of interest crowds out private investment particularly if government borrowing is used for financing of revenue deficits.

Thus in order to understand the renewed interest in the appropriate fiscal stance for stimulating growth, it is important to understand the following:

- The context and necessity of fiscal correction initiated since 1991, and
- The current state of government finances, as an important objection against the fiscal activism at the present juncture is the concern about the sustainability of public finances.

Central Government Finances

The fiscal trend of 1970s suggests that this was a period of moderate growth in public expenditure in line with revenue flows. The break came during eighties, when the total expenditure of the central government increased from 16.23 per cent of GDP in 1980-85 to 19.26 per cent in 1985-90 (Table 1). This was mainly due to the increase in non-plan expenditure, which climbed from 9.86 per cent of GDP during 1980-85 to 12.62 per cent during 1985-90. What is more striking about this increase is the rise in almost all categories of non plan expenditure namely interest payment, defence expenditure, subsidies, loans and grants to states & UTs as also other non plan expenditure. Also the plan expenditure remained upwards of 6 per cent throughout 1980s. So was the capital expenditure. And indeed the capital formation increased from 6.6 per cent of GDP during the first half of 80s to 7.2 per cent during the second half of 80s (Table 2). Thus it is clear that 1980s were characterized by a significant increase in government expenditure both plan and non-plan as also revenue and capital.

Table 1: Central Government Expenditure

Item	1980-81 to 1984-85	1985-86 to 1989-90	1990-91 to 1994-95	1995-96 to 1999-00	2000-01 to 2003-04
Percentage of GDPMP					
Non-Plan Expenditure	9.86	12.62	11.99	11.39	12.07
Interest Payment and Debt Servicing	2.08	3.18	4.13	4.40	4.70

Defence	2.65	3.15	2.48	2.29	2.30
Total Subsidy	1.33	1.83	1.67	1.21	1.51
- Food Subsidy	0.41	0.57	0.48	0.49	0.81
- Other Subsidy	0.92	1.26	1.20	0.72	0.70
Loan and advances to State	0.88	1.16	0.90	0.84	0.02
Grants to State & UT's	0.41	0.53	0.43	0.37	0.62
Other non-plan expenditure	2.50	2.77	2.38	2.27	2.91
Plan Expenditure	6.36	6.65	4.88	3.90	4.34
Total expenditure (Plan & Non-Plan)	16.23	19.26	16.87	15.29	16.41
Revenue expenditure	10.11	12.88	12.51	12.11	13.40
Capital expenditure	6.12	6.38	4.36	3.17	3.01
Percentage of Total Expenditure					
Non-Plan Expenditure	60.73	65.52	71.02	74.48	73.54
Interest Payment and Debt Servicing	12.81	16.52	24.59	28.82	28.72
Defence	16.37	16.35	14.70	15.00	14.09
Total Subsidy	8.19	9.52	9.86	7.89	9.20
- Food Subsidy	2.56	2.94	2.85	3.17	4.92
- Other Subsidy	5.62	6.58	7.01	4.72	4.28
Loan and advances to State	5.35	6.03	5.31	5.49	0.12
Grants to State & UT's	2.52	2.76	2.52	2.44	3.79
Other non-plan expenditure	15.49	14.35	14.04	14.83	17.61
Plan Expenditure	39.27	34.48	28.98	25.52	26.46
Total expenditure (Plan & Non-Plan)	100.00	100.00	100.00	100.00	100.00
Revenue expenditure	62.25	66.90	74.30	79.26	81.77
Capital expenditure	37.75	33.10	25.70	20.74	18.23

Source: Central Government Budget Papers

Table 2: Economic Classification of Central Government Expenditure

Sl. No.	Item	1980-81 to 1984-85	1985-86 to 1989-90	1990-91 to 1994-95	1995-96 to 1999-00	2000-01 to 2003-04
Percentage of GDPMP						
I.	Total Expenditure(II+III)	16.2	19.7	17.2	15.4	16.0
	Capital Formation	6.6	7.2	5.3	3.9	3.2
	Other Expenditure	9.7	12.5	11.9	11.5	12.8
II.	Final Outlays(A+B)	5.2	6.1	5.2	4.8	4.3
A.	Consumption Expenditure (i+ii)	3.7	4.4	3.7	3.5	3.5
(i)	Wages and salaries	1.7	2.0	1.6	1.6	1.5
(ii)	Commodities and Services	2.0	2.5	2.1	1.9	2.0
B.	Gross Capital formation (i+ii)	1.5	1.7	1.5	1.3	0.8
(i)	Gross Fixed Capital formation	1.4	1.7	1.5	1.3	0.8
(ii)	Increase in work stores	0.1	0.0	0.0	0.0	0.0
III.	Financial Resources provided to the rest of the economy (i)+(ii)=(iii)+(iv)+(v)+(vi)	11.0	13.5	12.0	10.6	11.7
(i)	Capital Formation	5.0	5.5	3.8	2.6	2.4
	- State Government	2.6	3.4	2.9	1.9	1.5
	- Non-Dept. Commercial Undertakings	2.2	1.8	0.8	0.4	0.4
	- Others	0.2	0.3	0.1	0.4	0.5
(ii)	Other Purposes	6.0	8.1	8.2	8.0	9.3
(iii)	Current transfers	5.2	7.2	7.8	7.6	9.0
(iv)	Capital transfers	1.0	1.4	1.3	1.1	1.1

(v)	Loans and advances	3.5	3.7	2.5	1.5	1.3
(vi)	Investments	1.4	1.2	0.4	0.3	0.2
Percentage of Total Expenditure						
I.	Total Expenditure(II+III)	100.0	100.0	100.0	100.0	100.0
	Capital Formation	40.4	36.5	30.6	25.4	20.1
	Other Expenditure	59.6	63.5	69.4	74.6	79.9
II.	Final Outlays(A+B)	32.2	31.2	30.0	30.9	26.9
A.	Consumption Expenditure (i+ii)	22.8	22.5	21.4	22.5	21.7
(i)	Wages and salaries	10.6	10.0	9.4	10.4	9.4
(ii)	Commodities and Services	12.2	12.5	12.0	12.1	12.3
B.	Gross Capital formation (i+ii)	9.3	8.7	8.6	8.4	5.1
(i)	Gross Fixed Capital formation	8.9	8.5	8.6	8.3	4.8
(ii)	Increase in work stores	0.4	0.2	0.0	0.1	0.3
III.	Financial Resources provided to the rest of the economy(i)+(ii)=(iii)+(iv)+(v)+(vi)	67.8	68.8	70.0	69.1	73.1
(i)	Capital Formation	31.1	27.8	22.0	16.9	15.0
	- State Government	16.2	17.1	16.7	12.0	9.4
	- Non-Dept. Commercial Undertakings	13.4	9.0	4.4	2.3	2.7
	- Others	1.5	1.7	0.9	2.6	2.8
(ii)	Other Purposes	36.8	41.0	48.0	52.2	58.2
(iii)	Current transfers	31.7	36.4	45.3	49.6	56.6
(iv)	Capital transfers	6.2	7.2	7.6	7.5	7.2
(v)	Loans and advances	21.5	18.9	14.5	10.1	7.9
(vi)	Investments	8.4	6.3	2.6	1.9	1.5

Source: Economic and Functional Classification of the Central Government Budget

Parallel to the increase in expenditure, the revenue receipts of the central government also went up from 9.1 per of GDP in 1980-85 to 10.5 per cent in 1985-90 (Table 3). As the base of direct taxes comprising of corporation tax and income tax was quite low; the buoyancy in tax revenue was experienced mainly due to an increase in indirect taxes. Here also, the increase mainly came from customs duty, which went up from 2.6 per cent of GDP during the first half of 1980s to 3.7 per cent during the second half of 1980s. This happened both due to an increases in the levels of customs duty (average tariff reached nearly 110 per cent towards late 80s) and an increase in imports (result of the first wave of liberalization during 80s). Thus, the second half of eighties witnessed a rather disturbing trend on the external front. While on the one hand imports increased due to gradually liberalizing policies, export competitiveness of the country got eroded due to higher customs duties creating a mismatch in trade account.

Table 3: Central Government's Revenue Receipts

Revenue Head	1980-81 to 1984-85	1985-86 to 1989-90	1990-91 to 1994-95	1995-96 to 1999-00	2000-01 to 2003-04
Percentage of GDPMP					
Revenue Receipts	9.1	10.5	9.5	9.1	9.3
- Tax Revenue (Net)	6.9	7.8	7.1	6.5	6.4
- Non-tax Revenue	2.2	2.6	2.4	2.5	2.8
Direct Tax (Net)	1.4	1.3	1.5	1.9	2.4
- Personal Income Tax	0.3	0.2	0.2	0.3	1.1
- Corporation Tax	1.1	1.0	1.2	1.4	1.3
Indirect Tax (net)	5.5	6.6	5.5	4.6	4.0
- Excise Duties (Net)	2.6	2.6	2.2	1.7	2.5
- Customs Duties	2.6	3.7	3.1	2.7	1.4
Percentage of Total Revenue Receipts					
Revenue Receipts	100.0	100.0	100.0	100.0	100.0
- Tax Revenue (Net)	76.1	75.1	74.4	72.1	69.3
- Non-tax Revenue	23.9	24.9	25.6	27.9	30.7
Direct Tax (Net)	15.6	12.4	16.2	21.0	26.1
- Personal Income Tax	3.0	2.3	2.6	3.8	11.6
- Corporation Tax	12.0	9.6	12.4	15.6	14.4
Indirect Tax (net)	60.5	62.7	58.2	51.2	43.2
- Excise Duties (Net)	28.7	25.3	23.6	19.2	26.7
- Customs Duties	28.8	35.3	32.4	30.1	14.7

Source: Handbook of Statistics on the Indian Economy, Reserve Bank of India, 2004.

What is worth noting for the decade of 1980s is that while the government expenditure and revenue both grew substantially, the growth in revenue could not keep pace with the growth in expenditure. Thus whereas the expenditure/GDP ratio increased by nearly 2.5 percentage points between 1980-85 and 1985-90, the revenue receipts/GDP ratio increased by only 1.4 percentage point for the same period. This not only widened the resource gap but also resulted in growing public debt and a higher fiscal deficit. Nevertheless, it did provide some fillip to GDP growth, which increased from 2.9 per cent during 1970s to 5.9 during the 1980s (Table 4). However, since the fiscal expansion relied heavily on public debt, interest payments & debt servicing increased from 2.2 per cent of GDP during the first half of 1980 to 3.2 per cent during the second half of 1980s. In fact, the interest payment became the largest component of the central government non-plan expenditure during the second half of 1980s overtaking the defence (Table 1). That this kind of public expenditure pattern is clearly non-sustainable was demonstrated by the twin balance of payment and fiscal crisis in 1990-91, where the high public debt spilled over to the external sector in the form of a deteriorating current account balance (Rangarajan and Mohanty, 1997).

Table 4: Central Government's Deficit and Combined Liabilities (% of GDPMP)

Period	Fiscal Deficit	Revenue Deficit	Primary Deficit	Combined Domestic Liabilities of Centre and States	External Liabilities of Centre	Combined Liabilities of Centre and States	Growth of Real GDPFC
1980-81 to 1984-85	5.9	1.0	3.8	41.3	7.2	48.5	5.7
1985-86 to 1989-90	7.7	2.4	4.5	53.1	6.3	59.5	6.0
1990-91 to 1994-95	6.3	3.0	2.2	55.7	5.5	61.1	5.0
1995-96 to 1999-00	5.5	3.1	1.1	55.4	3.6	59.0	6.5

2000-01 to 2003-04	5.4	3.9	0.8	70.3	2.6	72.9	5.6
--------------------	-----	-----	-----	------	-----	------	-----

Source: Handbook of Statistics on the Indian Economy, Reserve Bank of India, 2004.

Thus fiscal correction became inevitable to deal with the crisis. The economic reforms that was initiated post crisis indeed focussed on fiscal adjustment and consolidation, elimination of automatic monetisation of fiscal deficits and reform in taxation and investment policies. Consequently, the total expenditure of the central government as a percentage of GDP did show a sign of decline from 19.26 during 1985-90 to 16.87 per cent during 1990-95 and thereafter to 15.29 per cent, only to go up again to 16.41 per cent during 2000-04 (Table 1). Interestingly, both plan and non-plan expenditures as also the revenue expenditure followed the same pattern. Another striking aspect of the public expenditure of the post reform period is that even the different categories of non-plan expenditure firstly showed a decline during 1990s and then increased for the period 2000-04, with the exception of interest payment which continued to increase throughout 1990s and has now reached 4.7 per cent of GDP. In fact, interest payment is now the largest component of the non-plan expenditure. This is clearly a pointer to the fact that structural character acquired by the public expenditure in India has been a critical factor underlying the fiscal imbalances throughout 1990s and even now.

Countries pursuing fiscal correction programme seek to balance the increase in interest payments and other transfer obligations by reducing the public investment. In periods of fiscal consolidation, therefore the onus falls on the capital expenditure, as they are the less rigid components of expenditure. This is exactly what has happened in the case of India as well. While the interest burden kept mounting as a percentage of GDP over the years due to the rising debt burden, the capital expenditure continued to decline as a percentage of GDP. It became nearly half of what it was during 1980s in the second half of 1990s and thereafter (Table 1).

The net tax revenue, which was 7.1 per cent of GDP during the 1990-95, declined to 6.5 per cent during 1995-2000 and to 6.4 per cent during 2000-04 (Table 3). The loss in tax revenue was expected as a consequence of tax reform during the post 1991 period. However, there has been a consistent rise in the direct taxes to GDP ratio from about 1.5 per cent during the first half of nineties to 2.4 per cent now. On the other hand, the indirect taxes to GDP ratio came down from 5.5 per of GDP in 1990-95 to 4.0 per cent now. While customs duty collection consistently fell as a result of major cuts in the duties, the trajectory of excise duty collection followed the course of industrial ups and downs. Non-tax revenue during the same period increased from 2.4 per cent of GDP to 2.8 per cent. The revenue receipts, therefore, have remained at a level, which are little above 9 per cent over the last ten years.

As the capital receipts cover up the shortfall between revenue receipts and total expenditure of the government, we now turn towards the profile of capital receipts. Capital receipts have remained upwards of 6 per cent of GDP during 1980s and first half of nineties (Table 5). Consistent with decline in deficit during the second half of nineties, it came down to 5.9 per cent of GDP before increasing to 7.2 per cent during 2000-04. However, the distinctive feature of the capital receipts has been its changing pattern over a period of time. While the share of market borrowing in capital receipts has been continuously rising, the share of small savings increased till the second half of nineties and declined thereafter (Table 5). On other hand, external assistance is no longer an important source of financing for the government. This changing profile of capital receipts also had adverse impact on the government finances, as both market borrowing and small savings are more expensive sources of capital receipts and invariably lead to higher interest burden in future if the returns on investment are not commensurate. Put together, these sources accounted for nearly 47 per cent of the total capital receipts during 1980-85, but have gradually increased to about 62 per cent of total capital receipts now.

Table 5: Capital Receipts of Central Government

Capital Receipts Head	1980-81 to 1984-85	1985-86 to 1989-90	1990-91 to 1994-95	1995-96 to 1999-00	2000-01 to 2003-04
-----------------------	--------------------	--------------------	--------------------	--------------------	--------------------

Percentage of GDPMP					
Market Borrowings (Net)	1.8	1.7	1.7	2.7	3.7
Small Savings	1.0	1.3	1.0	1.1	0.7
Provident Funds	0.2	0.3	0.4	0.4	0.2
Special Deposits	0.5	1.2	1.0	0.4	0.3
Recoveries of Loans	1.2	1.1	0.8	0.6	1.3
Disinvestment*	0.0	0.0	0.3	0.1	0.2
External Loans (Net)	0.7	0.6	0.6	0.1	-0.1
Other Capital Receipts	0.6	0.6	0.4	0.5	0.8
Total Capital Receipts	6.0	6.9	6.2	5.9	7.2
Percentage of Total Capital Receipts					
Market Borrowings (Net)	30.4	25.4	26.4	45.7	52.1
Small Savings	16.7	19.3	16.4	18.2	10.0
Provident Funds	3.3	4.3	6.4	7.2	2.8
Special Deposits	7.7	17.5	16.5	7.8	4.3
Recoveries of Loans	20.8	15.8	13.6	9.7	17.1
Disinvestment*	0.0	0.0	5.2	1.6	3.1
External Loans (Net)	11.2	9.0	10.3	1.8	-0.8
Other Capital Receipts	9.9	8.7	6.3	7.9	11.3
Total Capital Receipts	100.0	100.0	100.0	100.0	100.0

Source: Handbook of Statistics on the Indian Economy, Reserve Bank of India, 2004.

The Government would find it more comfortable to service the debt burden provided the investments made by the borrowed funds are channeled into productive use. This being the case both tax as well as non tax revenue should have risen over the years. As the government borrows money to finance public goods and assets, tax revenue should rise as the improved public infrastructure would by increasing the efficiency and encouraging the private sector investment would lead to higher tax revenue. Further, by contributing to the government kitty through dividend payments it would also boost the non-tax revenue. However, as noted above, this did not happen. Thus, as the proportion of borrowed resources did not yield commensurate returns, increasingly the new investment had to be financed through borrowing and is clearly the case as the revenue surplus central government account of 1970s turned into revenue deficit since early 1980s. Faulty pricing structure, inefficiency of public sector enterprises, distorted resource allocation - all contributed to the government woes. In fact, excluding the petroleum companies, the post tax profits in manufacturing PSUs are still negative. Another disturbing feature of the management of public finances has been the utilization of a substantial portion of borrowing for financing revenue expenditure. Revenue deficit as a proportion of fiscal deficit has gone up from 4.4 per cent in 1981-82 to 44.8 per cent in 1991-92 and in 2003-04 it stood at 75.6 per cent. This simply means that over three fourth of the current borrowing is going towards financing of the current expenditure of central government and therefore do not yield any economic returns for the future. As revenue deficits tends to feed on itself because of the rising interest burden on budget, interest payment today account for about 70 per cent of tax revenue.

Thus continuance of high fiscal deficit and the long-term sustainability of government finances is certainly an issue at this juncture. There was an attempt to reduce the overall fiscal deficit and monetised deficit as a percentage of GDP during nineties. From the point of view of bringing down rate of inflation, safeguard the balance of payments and ensure conditions for stable growth this was necessary. But, doing away of monetisation coupled with deregulation of interest rate made the cost of borrowing much higher for the central government in the 1990s. As the monetisation of fiscal deficit was done away with the implicit cost of the fiscal deficit increased and interest rate deregulation meant that the cost of government borrowing had to be at the market rate, which was not the case earlier as the banks used to lend to the government at lower than market interest rates.

State Government Finances

As the Indian constitution demarcates the functional responsibilities and finances between the central and the state governments, the major responsibility for social sector expenditure, current and capital rests with the state governments. A secular decline in the fiscal balance of the state economies, marking a transition from revenue surplus till 1986-87 to one of deficit has not only persisted but also aggravated during the 1990s. Therefore it will be useful to scrutinize the state government finances.

The expenditure behaviour of the state government during the last twenty years nearly shows the similar pattern as was witnessed in the case of central government finances. Total expenditure of the states shows a substantial increase during the second half of 1980s. It increased from 15.49 per cent of GDP in 1980-85 to 16.28 per cent in 1985-90 (Table 6). Although post reforms and more so during the second half of 1990s, the combined expenditure of states showed considerable decline, it has again climbed up to 17.25 per cent of GDP lately. The compression in expenditure achieved at the state level during 1990s is characteristically no different from the one that was achieved at the central level, as the main adjustment here also was brought about by curtailing the capital expenditure. It came down from 4.78 per cent of GDP in the first half of 1980s to just 2.67 per cent during the second half of 1990s. As a percentage of total expenditure, capital expenditure declined from about 31 per cent in 1980-85 to 17.5 per cent in 1995-2000 and increased only marginally to 18.5 per cent during 2000-04. This clearly points towards the declining quality of state government expenditure. Similarity between the central and state government expenditure pattern do not end here. Like central government, the interest burden of the state governments has also been increasing over the years. From just 0.21 per cent of GDP in 1980-85, the interest burden of the state governments now has reached closer to 3 per cent of GDP. Also the other committed expenditures like pension after witnessing some decline in the second half of 1990s, has again gone up during 2000-04. As a consequence, the non-development expenditure in the revenue account has been consistently rising over the years. However, the sudden spurt, in the non-development expenditure more recently does need some explanation. This is clearly an outcome of the impact of the fifth central pay commission recommendations, which was implemented by various states towards the end of 1990s. In contrast, the developmental expenditure after reaching 8.6 per of GDP in 1985-90 has since fallen and is currently hovering around 7.7 per cent of GDP. Thus it is quite obvious that the increase in revenue expenditure over the years have mainly come from the rise in non-developmental expenditure, which has significantly dented the state governments' ability to spend on social services such as health, education and also on economic activities such as agriculture, rural development, irrigation etc.

Table 6: State Government Expenditure

Expenditure Head	1980-81 to 1984-85	1985-86 to 1989-90	1990-91 to 1994-95	1995-96 to 1999-00	2000-01 to 2003-04
Percentage of GDPMP					
Revenue Expenditure	10.71	12.30	12.82	12.60	14.05
1. Development Expenditure	7.60	8.58	8.41	7.63	7.71
2. Non-development Expenditure	2.98	3.59	4.26	4.78	6.10
- Interest Payments	0.21	1.33	1.74	1.87	2.82
- Pension	0.33	0.51	0.42	0.23	0.48
- Other Expenditure	2.44	1.75	2.10	2.68	2.80
3. Other Expenditure	0.14	0.14	0.14	0.18	0.24
Capital Expenditure	4.78	3.97	3.21	2.67	3.21
1. Capital Outlays	2.06	1.83	1.55	1.40	1.66
- Development	2.00	1.78	1.51	1.34	1.58
- Non-development	0.05	0.05	0.04	0.06	0.07
2. Other Expenditure	2.73	2.14	1.65	1.27	1.55
Total Expenditure	15.49	16.28	16.02	15.26	17.25

Percentage of Total Expenditure					
Revenue Expenditure	69.14	75.62	80.00	82.51	81.50
1. Development Expenditure	49.02	52.70	52.46	50.04	44.78
2. Non-development Expenditure	19.24	22.09	26.64	31.29	35.34
- Interest Payments	1.33	8.17	10.89	12.18	16.30
- Pension	2.14	3.14	2.66	1.54	2.71
- Other Expenditure	15.77	10.78	13.08	17.57	16.32
3. Other Expenditure	0.88	0.84	0.90	1.18	1.38
Capital Expenditure	30.86	24.38	20.00	17.49	18.50
1. Capital Outlays	13.28	11.26	9.68	9.17	9.58
- Development	12.94	10.93	9.41	8.81	9.15
- Non-development	0.34	0.33	0.26	0.36	0.43
2. Other Expenditure	17.58	13.11	10.32	8.32	8.92
Total Expenditure	100.00	100.00	100.00	100.00	100.00

Source: Handbook of Statistics on State Government Finances, Reserve Bank of India, 2004

A glance at the revenue receipts of the state reveals that it has fluctuated between 11 and a little over 12 per cent of GDP during the last twenty years or so (Table 7). The near stagnation in revenue receipts has primarily been on account of the sluggish nature of tax to GDP ratio, which has remained stuck at about 8 per cent. Yet, what is noteworthy about the states is the performance with regard to their own tax collection. Even while their share as a percentage of GDP in the central taxes was declining; they have been able to improve their own tax revenue collection over the years. Consequently, they have been able to improve their own tax to GDP ratio from 4.88 per cent in early eighties to 5.75 per cent now. Although the second half of nineties witnessed some decline in state's own tax to GDP ratio due to unhealthy competitive tax war among states to attract investment, the trend has reversed since 2000 when states agreed to bring about uniformity in sales tax with a view to move towards VAT. Therefore, unlike the central government, the states do not appear to have suffered on the tax revenue front.

Table 7: State Government Revenue and Capital Receipts

Revenue Head	1980-81 to 1984-85	1985-86 to 1989-90	1990-91 to 1994-95	1995-96 to 1999-00	2000-01 to 2003-04
Percentage of GDPMP					
A. Revenue Receipts	11.12	12.06	12.11	10.95	11.46
1. Tax Revenue	7.34	8.00	7.99	7.71	8.09
- Own Tax Revenue	4.88	5.34	5.41	5.27	5.75
- Share in Central Taxes	2.46	2.65	2.58	2.44	2.35
2. Non-tax Revenue	3.78	4.06	4.12	3.24	3.37
B. Capital Receipts	3.87	4.30	4.04	4.21	6.06
1. Loans from Centre (Gross)	2.19	2.54	1.96	1.77	1.06
2. Recoveries of Loans	0.37	0.29	0.37	0.29	0.35
3. Other Receipts	1.31	1.47	1.71	2.16	4.65
Total Receipts	14.99	16.36	16.15	15.16	17.51
Percentage of Total Receipts					
A. Revenue Receipts	74.23	73.74	75.03	72.34	65.64
1. Tax Revenue	49.01	48.91	49.49	50.92	46.38
- Own Tax Revenue	32.60	32.68	33.51	34.77	32.92
- Share in Central Taxes	16.41	16.23	15.98	16.15	13.46
2. Non-tax Revenue	25.22	24.83	25.54	21.41	19.26
B. Capital Receipts	25.77	26.26	24.97	27.66	34.36
1. Loans from Centre (Gross)	14.60	15.51	12.12	11.73	6.05

2. Recoveries of Loans	2.44	1.75	2.25	1.92	1.97
3. Other Receipts	8.73	9.00	10.60	14.01	26.33
Total Receipts	100.00	100.00	100.00	100.00	100.00

Source: Handbook of Statistics on the Indian Economy, Reserve Bank of India, 2004

Table 8: Financial Performance of the State power sector (Rs. Crore)

Gross Subsidy involved	1991-92	2002-03*	2003-04 (RE)	2004-05 (AP)
(i) On account of sale of electricity to				
(a) Agriculture	5938	21845	22793	24012
(b) Domestic	1310	8534	8210	8967
(c) Inter-State Sales	201	189	938	818
Total	7449	30568	31941	33797
(ii) Subventions Received from State Govts.	2045	12996	11427	11141
(iii) Net Subsidy	5404	17572	20514	22656
(iv) Surplus Generated by sale to other sectors	2173	4797	5668	6424
(v) Uncovered Subsidy	3231	12775	14846	16232
Commercial Losses				
(i) Commercial Losses(excluding subsidy) @	4117	21382	21517	21698
(ii) Commercial Losses (including subsidy)	NA	8686	10090	10556
Rate of Return (ROR %)#	-12.7	-31.64	-30.86	-28.8
Revenue Mobilisation				
Additional Revenue Mobilisation from achieving				
(a) 3% ROR	4959	23410	23609	23744
(b) From introducing 50 paise per unit from Agriculture/Irrigation	2176	456	250	533

RE: Revised Estimates * Provisional

AP: Annual Plan Projection # for losses without subsidy

@ Commercial losses are different from uncovered subsidy because they include financial results of other activities undertaken by the SEBs.

Note: 1. The information relating to the subsidy for Agriculture, Domestic and Inter-state sales for the years 2002-03, 2003-04 and 2004-05 in respect of Orissa and Delhi is not available, as the distribution is entrusted to the Private Companies. The information regarding commercial losses pertains to GRIDCO of Orissa and Transmission Company of Delhi only.

2. Information in case of Andhra Pradesh, Haryana, Rajasthan, Uttar Pradesh, Uttranchal, West Bengal and Karnataka states is relating to transmission and distribution companies set up after the reforms. In case of other states, the information pertains to SEBs. 3. The estimates for next fixed assets in respect of Uttranchal Power Corporation have not been furnished and hence the over all ROR calculated for all the SEBs may not reflect the correct picture.

Source: Planning Commission as quoted in Economic Survey, 2003-04.

As against this, the performance of the states with respect to non-tax revenue has been wanting. Indeed the non-tax revenue collection showed some improvement during the late eighties and early nineties when as ratio of GDP it crossed 4 per cent but the same has declined since then to 3.7 per cent now. The reason for this decline is none other than the poor recovery of user charges from the users of these goods & services on the one hand and less than adequate returns from public enterprises on the other hand. The performance of the state electricity boards has been the single most important drain on the finances of the state governments. The gross subsidy involved in the power sector has gone up from Rs. 7,500 crore in 1991-92 to Rs. 34,000 crore in 2004-05. This has mainly been on account of sale of electricity to agriculture (Table 8). The disappointing performance of this sector is also evident from the rising trend of negative return which has increased from -12.7 per cent on capital in 1991-92 to about -31 per cent in 2003-04.

Since in a federal set up like ours, states apart from their own resources, rely heavily on the resources received from the centre, their fiscal position owes a lot to the transfer from the centre. Under the existing system, the central assistance provided for the execution of state plans as

recommended by the planning commission, is based on the revised Gadgil formula³. And these fiscal transfers broadly aim at correcting both vertical and horizontal imbalance⁴. As the fiscal position of the centre itself deteriorated towards the end of 1980s their capacity to transfer resources to states also dwindled. This is clearly reflected in the gross loan and transfers from centre to state under the head capital receipt declining as a percentage of GDP from 2.5 per cent in the second half of 1980s to 1 per cent now (Table 7). This has severely eroded states governments ability to invest in social and physical infrastructure, as governments at the sub national level can not resort to deficit financing. Although states are free to raise market borrowings to meet any mismatch between their revenue and expenditure they can do so only if they do not owe any debt to the centre. As all states are currently debt ridden their market borrowing is governed by the central government and executed by the RBI. Moreover, the RBI carries out such borrowings at the same rate for all the states. Thus there is no link between the creditworthiness of a state and the interest rate on such loans. More importantly, as the servicing of these borrowings becomes the part of the budget, there is hardly any relationship between the borrowed resources and the final outcome of its deployment. Borrowing by itself is not a serious problem so long as it could serve the developmental needs and requirement of the government. However, borrowing to meet the current revenue expenditure requirement may not necessarily ensure adequate returns to meet the interest burden and repayment of loan liabilities. This is what seems to have happened towards the end of 1990s, particularly due to the adoption of fifth central pay commission's recommendations. The states borrowed heavily and the interest burden kept mounting. Thus interest payment as a percentage of revenue receipts reached 25.3 per cent in 2003-04 as against 13.5 per cent in 1991-92. However, the point that part of the surge in interest payment was also due to the relatively high rate of interest rates on borrowing during 1990s should not be overlooked as 45 per cent of the state government's outstanding loans in 2003 were borrowed on an interest above 10 per cent. Also, major part of the fiscal deficit of the states is now financed by small savings, which undoubtedly is an expensive source of finance⁵.

Like centre again the more worrisome feature of the fiscal health of the states is the fiscal deficit, which has aggravated in recent years. The fiscal deficit, which was mostly between 2 to 3 per cent of GDP during 1980-81 and 1997-98, has gone beyond 4 per cent in recent years (Table 9). Similarly revenue deficit which was less than 1 per cent till the middle of 1990s, has gone up considerably in the second half of 1990s and thereafter. This suggests that the higher fiscal deficits in recent years have primarily been driven by the deficit on revenue account. That the worsening fiscal situation of the state governments have severely impacted their ability to finance investment expenditure becomes quite evident from the decline in capital outlays as a proportion of fiscal deficit from 62 per cent in 1980-85 to less than 43 per cent now. Indeed this will have serious implication for growth and development of the state economies. Thus borrowing by the state governments to finance more and more of revenue expenditure will only add to the outstanding debt leading to increasing interest payment. This simply means that with slow growth in revenue receipts as against expenditure, the emergence of a self-perpetuating debt and deficit spiral is not a distant scenario lest corrective measures are initiated.

Table 9: States Combined Deficit and its Financing Pattern (% of GDPMP)

Year	Fiscal	Decomposition of Fiscal Deficit	Financing of Fiscal Deficit
------	--------	---------------------------------	-----------------------------

³ Under this formula 30 per cent of the total amount to be released for all states is earmarked for the special category states and the remaining is distributed among the other states on the basis of population, per capita SDP, tax efforts and special problems having respective percentage weight of 60, 25, 7.5 and 7.5. The percentage share of grants and loans in the total assistance provided to special category states is 90:10, while the respective ratio for non-special category states is 30:70.

⁴ The vertical imbalance arises due to the inadequacy of revenues of state governments to meet their expenditure, which in turn partly arises on account of asymmetrical assignment of functional responsibilities and conferment of powers to raise resources among various levels of government. At the other end, the disparities in the revenue capacity of the constituent units of the federation have been primarily responsible for the emergence of horizontal imbalances.

⁵ To take advantage of the relatively low interest rates in recent years, there have been some attempts to swap the high cost debts of the states with low cost debt.

	Deficit	Revenue Deficit	Capital Outlays	Net Lending	Loans from Centre (Net)	Market Borrowings (Net)	Special Securities to NSSF	Others
1980-81 to 1984-85	2.78	-0.41	2.06	1.13	1.31	0.22	-	1.24
1985-86 to 1989-90	2.96	0.24	1.83	0.88	1.65	0.42	-	0.89
1990-91 to 1994-95	2.82	0.71	1.55	0.57	1.39	0.45	-	0.99
1995-96 to 1999-00	3.46	1.65	1.40	0.41	1.30	0.54	-	1.34
2000-01 to 2003-04	4.44	2.51	1.65	0.28	0.01	1.04	1.83	1.56

Source: Handbook of Statistics on the Indian Economy, Reserve Bank of India, 2004

Government Deficit, its Implications and Growth

A key question confronting the policy debate currently is whether fiscal activism can play a significant role in promoting growth. Since the problem has been posed in a context when both central and state governments are already fiscally stressed, the dilemma of using fiscal policy to this effect has become that much more complex. Had the government finances been in a healthy shape perhaps use of fiscal policy would not have been such a difficult choice. Thus whether the creation of fiscal deficit have an adverse impact on growth assumes significance. A small exercise in this regard both at the aggregate (center plus state) as also for the major states seem to suggest that the link between the growth and fiscal deficit is very weak. For the exercise, fiscal deficit as a ratio of GDP/GSDP was sought to be linked to the rate of growth of GDP/GSDP. The data set used was for the period 1980-81 to 2002-03. Before running the regression, both the variables were tested for the presence of unit roots. The results are given in Table 10. Given the results of unit root test regressions were run both for the entire period as also for the pre and post reforms period and the results are given in Table -11 & 12 & 13. While the direction of the results are mixed, with few cases suggesting positive impact of fiscal deficit on growth and few suggesting the opposite, the evidence in most of the cases is statistically insignificant.

Table 10: Testing for Stationarity of State Fiscal Deficit to GSDP Ratio and Growth of Real GSDP (1980-81 to 2002-03)

States	Stationarity of Fiscal Deficit to Nominal GSDP Ratio		Stationarity of Growth of State Real GSDP	
	Augmented Dickey-Fuller Test	Phillip-Perron Test	Augmented Dickey-Fuller Test	Phillip-Perron Test
Andhra Pradesh	Stationary, First Difference	Stationary, First Difference	Stationary, Level *	Stationary, Level
Assam	Stationary, First Difference	Stationary, First Difference	Stationary, Level *	Stationary, Level
Bihar	Stationary, First Difference	Stationary, First Difference	Stationary, Level *	Stationary, Level
Gujarat	Stationary, First Difference	Stationary, First Difference	Stationary, Level	Stationary, Level
Haryana	Stationary, First Difference	Stationary, First Difference	Stationary, Level	Stationary, Level
Himachal Pradesh	Stationary, First Difference	Stationary, First Difference	Stationary, Level *	Stationary, Level
Jammu and Kashmir	Stationary, Second Difference	Stationary, Second Difference	Stationary, Level *	Stationary, Level
Karnataka	Stationary, First Difference **	Stationary, First Difference	Stationary, Level **	Stationary, Level
Kerala	Stationary, First Difference	Stationary, First Difference	Stationary, Level **	Stationary, Level
Madhya Pradesh	Stationary, First	Stationary, First	Stationary, Level *	Stationary, Level

	Difference	Difference		
Maharashtra	Stationary, First Difference *	Stationary, First Difference	Stationary, Level **	Stationary, Level
Orissa	Stationary, First Difference *	Stationary, First Difference	Stationary, Level	Stationary, Level
Punjab	Stationary, First Difference	Stationary, First Difference	Stationary, Level	Stationary, Level
Rajasthan	Stationary, First Difference	Stationary, First Difference	Stationary, Level *	Stationary, Level
Tamil Nadu	Stationary, First Difference *	Stationary, First Difference	Stationary, Level *	Stationary, Level
Uttar Pradesh	Stationary, First Difference *	Stationary, First Difference	Stationary, Level *	Stationary, Level
West Bengal	Stationary, First Difference	Stationary, First Difference	Stationary, Level	Stationary, Level
All India	Stationary, First Difference	Stationary, First Difference	Stationary, Level *	Stationary, Level

* Significant at 5 per cent, ** Significant at 10 per cent and rest are significant at 1 per cent
Bihar, Madhya Pradesh and Uttar Pradesh are Undivided States

Table 11: Explaining Variation in Growth (1980-81 to 2002-03)

(Dependent Variable: State Growth Rate, Independent Variable: First difference of State Fiscal Deficit to GSDP ratio, for Jammu and Kashmir it is second difference)

States	Constant	Slope	R ²
Andhra Pradesh	4.9161	-0.1902 ***	0.0026
Assam	3.3727	0.1767 ***	0.0306
Bihar	4.3362	-1.3343 ***	0.1122
Gujarat	6.8313	-3.7336 *	0.2484
Haryana	5.6365	-1.9072 ***	0.0678
Himachal Pradesh	5.3351	0.0048 ***	0.000036
Jammu and Kashmir	4.2331	-0.5069 *	0.3374
Karnataka	5.8087	-0.2043 ***	0.0030
Kerala	4.0722	0.0037 ***	0.000001
Madhya Pradesh	2.7017	-1.0666 ***	0.0092
Maharashtra	5.4906	3.3274 *	0.1863
Orissa	4.1492	-2.2347 ***	0.1135
Punjab	4.7117	-0.0818 ***	0.0049
Rajasthan	6.4993	-3.2486 *	0.2065
Tamil Nadu	5.7608	-1.9956 **	0.1761
Uttar Pradesh	3.8096	-0.3208 ***	0.0151
West Bengal	5.6805	-0.2960 ***	0.0171
All India	5.5442	0.2950 ***	0.0281

* Significant at 5 per cent, ** Significant at 10 per cent, *** insignificant

Table 12: Explaining Variation in Growth (1980-81 to 1990-91)

(Dependent Variable: State Growth Rate, Independent Variable: First difference of State Fiscal Deficit to GSDP ratio, for Jammu and Kashmir it is second difference)

States	Constant	Slope	R ²
Andhra Pradesh	4.700288	-1.392975 ***	0.15
Assam	3.938768	0.379572 ***	0.10
Bihar	4.915647	-2.540531 **	0.33
Gujarat	7.566830	-6.804211 *	0.48
Haryana	6.142410	-0.418814 ***	0.004

Himachal Pradesh	5.390300	-0.330382 ***	0.04
Jammu and Kashmir	3.962382	-0.970507 *	0.72
Karnataka	4.672038	-0.166312 ***	0.003
Kerala	2.555716	-0.162603 ***	0.002
Madhya Pradesh	4.053126	-0.669761 ***	0.006
Maharashtra	5.956437	1.869783 ***	0.07
Orissa	4.560321	-7.006539 *	0.58
Punjab	4.970510	-0.007070 ***	0.00003
Rajasthan	7.127618	-4.282544 **	0.33
Tamil Nadu	6.030633	-6.290878 **	0.35
Uttar Pradesh	4.381107	0.236460 ***	0.01
West Bengal	4.533752	-1.412024 ***	0.16
All India	5.662335	-0.131711 ***	0.005

* Significant at 5 per cent, ** Significant at 10 per cent, *** insignificant

Table 13: Explaining Variation in Growth (1991-92 to 2002-03)

(Dependent Variable: State Growth Rate, Independent Variable: First difference of State Fiscal Deficit to GSDP ratio, for Jammu and Kashmir it is second difference)

States	Constant	Slope	R ²
Andhra Pradesh	4.816989	1.955229 **	0.26
Assam	2.829488	-0.106108 ***	0.03
Bihar	3.965581	-0.837313 ***	0.05
Gujarat	6.703389	-2.103973 ***	0.13
Haryana	5.353082	-3.343029 ***	0.19
Himachal Pradesh	5.678171	0.093501 ***	0.07
Jammu and Kashmir	4.494772	0.054095 ***	0.03
Karnataka	6.887792	-0.745088 ***	0.03
Kerala	5.491346	0.451734 ***	0.05
Madhya Pradesh	1.549845	-0.830509 ***	0.005
Maharashtra	4.871411	4.529198 **	0.31
Orissa	4.140453	0.929528 ***	0.05
Punjab	4.459337	-0.331325 ***	0.10
Rajasthan	5.067217	-1.429300 ***	0.04
Tamil Nadu	5.766319	-1.366424 ***	0.21
Uttar Pradesh	3.336389	-0.755078 ***	0.08
West Bengal	6.720008	0.052783 ***	0.003
All India	5.506541	0.674744 ***	0.17

* Significant at 5 per cent, ** Significant at 10 per cent, *** insignificant

However, as the discussion in the preceding sections clearly points out that the problem with fiscal situation both at the centre and state is currently as much about its quantum as much about its quality. Put together the fiscal deficit of center plus state during 2000-04 works out to be 9.6 per cent of GDP, which is much higher than both the first and second half of 1990s (Table 14). And the combined revenue deficit of the centre and states has gone up from 3.7 per of GDP in 1990-95 to 6.6 of GDP in 2000-04. In simple terms, this means that of nearly one tenth of the national income that the government is currently borrowing more than two third of this is being utilized for current expenditure. Governments all over the world borrows to smoothen out the mismatch between their earnings and expenditure. But given the level of fiscal deficit, if its size is an issue, then the purpose for which it is used is even a bigger issue. To test this we tried to link the relative growth of GSDP across 16 major states with the growth of gross fiscal deficit as also the revenue deficit along with the relative share of industry in GSDP in 1980-81 and relative index of infrastructure development in 1980-81⁶. The regression results of this exercise are given below.

$$\text{GRLAV} = -3.444 + 0.005 \text{RELINF} + 1.602 \text{SHINDR} + 0.001 \text{GRFDEF}$$

$$\qquad\qquad\qquad (1.80) \qquad\qquad\qquad (4.95) \qquad\qquad\qquad (2.11)$$

$$R^2 = 0.87$$

$$\text{GRLAV} = -2.923 + 0.004 \text{RELINF} + 1.636 \text{SHINDR} - 0.001 \text{R_FDEF}$$

$$\qquad\qquad\qquad (1.36) \qquad\qquad\qquad (6.31) \qquad\qquad\qquad (-3.02)$$

$$R^2 = 0.92$$

(Figures in parentheses are t values)

⁶The two additional variable namely the relative share of industry in GSDP and relative index of infrastructure development have been included in the regression exercise a la Barro and Martin (1995) who emphasized that growth differentials across countries owe a lot to the initial conditions in the aforesaid variables.

Where,
 GRLAV : Relative growth of GSDP (All India = 100) during the period 1980-81 to 1999-00.
 RELINF : Relative index of infrastructure development⁷ (All India = 100) for the year 1980-81.
 SHINDR : Relative Share of Industry (All India = 100) in Real Gross State Domestic Product for the year 1980-81.
 GRFDEF : Relative Growth of Gross Fiscal Deficit (All India = 100) during the period 1980-81 to 1999-00.
 R_FDEF : Relative Revenue Deficit to Fiscal Deficit Ratio (All India = 100) during the period 1980-81 to 1999-00.

The crucial result of the equations is given by the signs of GRFDEF and R_FDEF. This supports the assertion made above that more than the fiscal deficit it is the growing revenue deficit, which is alarming as it has an inverse relationship with growth⁸. Thus one wonders if the present trend continues what will be left for undertaking capital expenditure out of the borrowed amount.

Table 14: Combined Central and State Governments Deficit (% of GDPMP)

Period	Fiscal Deficit	Revenue Deficit	Primary Deficit
1980-81 to 1984-85	7.19	0.64	4.77
1985-86 to 1989-90	8.88	2.67	5.22
1990-91 to 1994-95	7.76	3.73	2.92
1995-96 to 1999-00	7.76	4.71	2.50
2000-01 to 2003-04	9.64	6.64	3.33

Source: Handbook of Statistics on the Indian Economy, Reserve Bank of India, 2004

However, the fact that high government deficit and sharp increase in the size of government debt during the second half of 1990's and thereafter did not have any adverse macroeconomic impact as was witnessed during the beginning of 1990s, led to the revival of the view (also noted above) of late that higher fiscal deficit need not be a matter of much concern. It was argued that fiscal deficit would be inflationary only if system is at full employment or is characterized by supply bottlenecks in certain sectors. Given the fact that there is excess industrial capacity along with large food stocks, large foreign exchange reserve and low inflation a monetized deficit is not only non inflationary, but virtuous from the point of view of growth (Chandrashekhar, 2000).

The argument looks credible, at the first instance, as indeed there was no spill over effect of higher fiscal deficit on the external sector. However, we must not forget that this was a period marked by dampened investment demand from the private sector with recessionary conditions. Consequently the overall saving - investment gap narrowed down and the same was reflected in three years of current account surplus ending 2003-04. Also, the recessionary conditions coupled with the availability of sizable forex reserves, large food stocks and downward trend in global prices helped in containing inflationary pressure in the Indian economy. Furthermore, continuing foreign exchange inflows and the recessionary conditions, even while fiscal deficit was rising helped RBI to pursue a softer interest rate regime. However, we must recognize that the fortuitous conditions that have restricted the adverse macroeconomic impact of high fiscal deficit are transitory in nature. And therefore, revival of economic activity, spurred by a pick up in the private investment demand, if is accompanied by a rise in fiscal deficit, it could increase the savings-investment gap and eventually raise interest rate and also widen the current account deficit. The problem could be compounded if inflationary pressure reemerge due to buoyant economic activity or some exogenous shock or a mixture of both. Thus, if due to conducive conditions there has not been any adverse macroeconomic impact of high fiscal deficit lately, this does not mean that high fiscal deficit may not be potentially damaging for the economy.

⁷ Relative index of infrastructure development is based on 13 economic and social variables as reported in "Profile of States", CMIE, March 1997.

⁸ See Asian Development Bank (2002).

Further, in the context of role of fiscal policy to promote growth, it needs to be recognized that the fiscal stance not only affects output alone, but also the variability of output. Imbalances between aggregate demand and aggregate supply feed back into the realized fiscal deficit. Given this simultaneity, it will be important to understand whether the fiscal policy automatically smoothens the business cycle or discretionary interventions are required. This is attempted by decomposing fiscal deficit into cyclical component (responsive to cycles) and structural component (unresponsive to cycles). It has been found that fiscal deficits in India are predominantly structural both at the central as well as at the state level (RBI, 2002). This suggests that discretionary counter cyclical interventions have an important role to play in the Indian context. In this sense the size of the fiscal deficit (central & state governments combined for the period 2000-04) is indeed alarming since it erodes the government's ability to intervene and undertake counter cyclical measures.

Again with regard to the quality of fiscal deficit, it has been observed that the government consumption expenditure does not have a lasting impact on private consumption. Like wise even in case of capital expenditure, dynamics between government spending and private sector behaviour will have to be borne in mind, as it has been found that while the government investment in manufacturing crowds out private investment, on infrastructure sector it crowds in private investment (RBI, 2002).

A fiscal correction, therefore, will have to focus as much on the quantum of fiscal deficit as much on its end use, tilting the government expenditure in favour of investment in infrastructure as against consumption expenditure.

Concluding Observation

It needs no emphasis that the long-term implications of running fiscal deficits continuously relate to the rise in interest burden and growth in debt to GDP ratio. However, public debt financing of continuous public deficit will be sustainable if real interest rates are lower than real output growth in the economy. When real interest rate exceed real output growth the persistence of a primary deficit leads to an explosive path of public debt, endangering the solvency of the government debt. A number of studies have tested sustainability of public debt in India (Buiters & Patel, 1997; Joshi & Little, 1996, Rajaraman & Mukhopadhyay, 1998; and RBI, 2002) and there is overwhelming evidence that solvency of government debt can not be taken for granted. Thus the goal should be to stabilize or reduce the debt to GDP ratio for which generating primary fiscal surplus would be crucial (Rangarajan & Srivastava, 2003). The focus of fiscal reform therefore should be on cutting primary deficit, without reducing capital expenditure. Reduction in primary deficit will then automatically mean reduction in revenue deficit. At the current juncture resource mobilization by augmenting tax revenue, earning economic return on past government investment should be a priority, because there is ample scope for enhancing revenues as against compressing expenditure due to its downward rigidity. In the context of growth, fiscal adjustment needs to be tailored to reverse the declining trend in infrastructure investment and basic social services and to improve the productivity of the resource used in public sector. These measures in our view will not only be beneficial for promoting growth in the long run but would also be critical in ensuring the fiscal health of the government.

Policy Recommendation

Given the expenditure pattern of both centre and states an obvious starting point for fiscal correction would be reduction in revenue expenditure. However, given that a substantial proportion of revenue expenditure is of committed variety, it is true that they are somewhat rigid. But this only means that they should have remained at the existing level and not grown over the time. On the contrary, revenue expenditure have remained more or less at the same level as percentage of GDP throughout 1990s and even gone up thereafter. While this was partly due to the growth in interest payment, it was also due to competitive populism giving rise to unjustified

increase in agricultural support prices, power and water subsidies, a large increase in pay to the government servants etc. Thus if downward rigidity is a constraining factor for reducing revenue expenditure, the political economy of the country is an aggravating factor for the growth of revenue expenditure. This, however, does mean that expenditure compression should not be a goal for the government. The FRBM act passed recently in the parliament, and similar act enacted by the states such as Karnataka, Punjab, Kerala, Tamil Nadu, Maharashtra and Uttar Pradesh will bring about some fiscal discipline in managing public finances. Augmenting revenue and earning economic return on investment, therefore, acquires more significance in the present context. Moreover, as compared to international standards while our tax to GDP ratio is low, expenditure to GDP ratio is almost comparable (See Box 1).

The main instruments through which revenue augmentation can take place is as follows:

- Tax revenue
- Non-tax revenue — user charges and
- Disinvestment

As has been noted above, through out 1990s and even thereafter tax to GDP ratio at the central level has fallen. The fall in the tax to GDP ratio is largely an outcome of the decline in customs and excise duties as high tax revenues in 1980s had been raised through high rates and irrational structure of these taxes. A reform of the tax structure was therefore necessary to eliminate the distortion in resource allocation and minimize cost escalation to make domestic industry cost and export competitive and the post reform period did witness substantial progress on this front. However, since the Indian economy is gradually getting more intensely integrated with the global economy there is growing pressure to further rationalize the customs duty as by international standards they are still very high. There is already indication that soon they will be brought down to the match the Asian level. This means that customs duty, as a source of tax revenue, would further come under pressure. Buoyancy in indirect taxes therefore would have to largely come from excise duty at the central level and sales tax at the state level, which is linked to the industrial growth in particular and overall growth in general. Thus as the industrial growth slowed down during second half 1990s so was the excise and sales tax revenues. And as the industrial growth picked up recently, both excise and sales tax revenues have again gone up (Table 3 and 6).

Part of the reason for the stagnation of overall tax to GDP is also the changing structure of the economy. In post reform period, the GDP growth primarily came from the services sector, which is largely untaxed. A good deal of indirect tax revenue thus can come from this sector. A beginning although has been made, a lot more still needs to be done on this front. Agriculture, whose share in GDP though is shrinking, is a potential area for taxation, but has remained outside the tax net and will remain so in the foreseeable future for political economy reasons.

Table 15: Financial Results of Irrigation and Multipurpose River Valley Projects (All-India, Rs Crore)

Year	Gross Receipts	Working Expenses, including Interest on Capital Outlays	Profit/loss	Percentage Recovery of Working Expenses through Gross Receipts
1976-77	104.7	287.7	-183.0	36.4
1977-78	96.9	342.7	-245.8	28.3
1978-79	108.1	410.7	-302.6	26.3
1979-80	100.7	432.8	-332.1	23.3
1980-81	103.4	527.2	-423.8	19.6
1981-82	120.2	680.9	-560.7	17.7
1982-83	117.1	1110.4	-993.3	10.5
1983-84	165.1	836.7	-671.6	19.7
1984-85	129.7	969.7	-840.0	13.4

1985-86	223.8	1168.6	-944.8	19.2
1986-87	166.7	1356.9	-1190.2	12.3
1987-88	138.7	1440.3	-1301.6	9.6
1988-89	166.4	2128.0	-1961.6	7.8
1989-90	207.6	2223.8	-2016.2	9.3
1990-91	228.9	2476.3	-2247.4	9.2
1991-92	227.3	2803.3	-2576.0	8.1
1992-93	320.2	3116.9	-2796.7	10.3
1993-94	477.4	3629.9	-3152.5	13.2
1994-95	445.1	4352.4	-3907.3	10.2
1995-96	498.2	4819.0	-4320.8	10.3
1996-97	458.4	5446.1	-4987.7	8.4
1997-98	363.3	6257.7	-5894.4	5.8
1998-99	455.8	7215.3	-6759.5	6.3

Source: 'Water and Related Statistics', Information Systems Organisation, Water Planning and Projects Wing, Central Water Commission, New Delhi, 2002

Under non-tax revenue head let us first look at public services. Among other, these services include power, water supply, irrigation and transport. Unrealistically low user charges imposed on these services has meant that firstly the government is unable to recover the economic cost of these services and subsequently had provide regular budgetary support to maintain these services. In the case of power alone the gross subsidy is estimated to be around Rs. 34,000 crore (Table 8). Even in case of irrigation and multipurpose river valley projects the gross receipts (cost recovery) as a percentage of working expenses has declined from 36 per cent in 1976-77 to mere 6.3 per cent in 1998-99 (Table 15). As per an estimate of the government the subsidies on non-merit goods was as much as 10.7 per cent of GDP in mid nineties. Thus it is not difficult to understand that the huge public investment undertaken by the government over the years in stead of providing adequate financial returns has become a drain on the government resources. Non imposition of appropriate user charges has often been justified on the basis of equity consideration. However without going in to the detail it would suffice to say that this has not been the case most often. Thus even a modest correction in the user charges of these services can go a long way in improving the fiscal health of the government. But, it is easier said than done due to the politicized nature of these services. Similarly the disinvestment and privatization both of central and state level PSUs can play an important role in mobilizing additional revenue for the government.

References

- Acharya, S. (2001), "High Fiscal Deficits Hurt Growth," The Economic Times, November 1.
- Asian Development Bank (2002), The State of Government Finances, Fiscal reforms and the Role of ADB, in Economic and Sector Studies.
- Bagchi, A, and, N. Stern (1994). "Introduction in Tax Policy and Planning in Developing Countries", O.U.P, Delhi.
- Bagchi, A (2001), "Perspective on Correcting Fiscal Imbalances in the Indian Economy – Some comments", ICRA Bulletin (January-June).
- Barro, R and X Sala-i-Martin (1995). Economic Growth. McGraw Hill Inc, New York.
- Buiter, W and U Patel (1997), " Solvency and Fiscal Correction in India: An Analytical Discussion", in Sudipto Mundle (ed), Fiscal Policy in India, Oxford University Press, New Delhi.
- Chandrashekhar, C.P. (2000), ' Economic Reforms and the Budget', Economic and Political Weekly, April 1, Vol 35, No 14.
- CWC (2002), 'Water and Related Statistics', Information Systems Organisation, Water Planning and Projects Wing, Central Water Commission, New Delhi, 2002
- Government of India (2004), Economic Survey, 2003-04.
- Joshi, D. K. & J. Bajaj (2001), "Government Finances" in Economic and Policy reforms in India. NCAER, New Delhi.
- Joshi, V and I. M. D. Little (1996), India's economic reforms 1991 – 2001, Oxford University Press, New Delhi.
- Lahiri, A and R. Kannan (2001), "India's Fiscal Deficits and Their Sustainability. Discussion Paper No. 5, NIPFP.
- Mohan, R. (2000), "Fiscal Correction for Economic Growth: Data Analysis and Suggestions", Economic and Political Weekly, June 10.
- Patnaik, P. (2001), "The Humbug of Finance", www.macrosan.com

Rangarajan, C. and M. S. Mohanty (1997), "Fiscal Deficit, External Balance and Monetary Growth: Evidence on the Indian Economy", RBI Occasional Papers, Vol. 18, No. 4.

Rangarajan, C. and D. K. Srivastava (2003), "Dynamics of Debt Accumulation in India: Impact of Primary Deficit, Growth and Interest Rate", Economic and Political Weekly, November 15, Vol 35, No 14.

Rajaraman, I and A Mukhopadhyay (2000), "Sustainability of Public Domestic Debt in India," in D.K. Srivastava (ed), Fiscal Federalism in India – Contemporary Challenges, Issues before the Eleventh Finance Commission, Har Anand Publications, New Delhi.

Rakshit, Mihir (2000), "On Correcting Fiscal Imbalances in the Indian Economy – some Perspective ICRA Bulletin.

RBI (2002), "The Role of Fiscal Policy in Reinvigorating Growth", in Report on Currency and Finance 2000-01, Reserve Bank of India.

RBI (2004), Handbook of Statistics on the Indian Economy, 2003-04, Reserve Bank of India.

RBI (2004), Handbook of Statistics on State Government Finances, Reserve Bank of India.

Shetty S.L. (2001), "Reviving the Economy – some Explorations", Economic and Political Weekly.

BOX 1: India's Tax/ Expenditure to GDP Ratio in an International Context

Tax as also total revenue as a percentage of GDP in India are low by international standards. Moving from the first half of nineties to the second half of nineties, while some of the Latin American countries were able increase there Tax to GDP ratio, exactly opposite happened for some of the Asian countries including India.

General Government Total Revenue, Tax Revenue & Total Expenditure as a percentage of GDP							
Countries	Total Revenue		Tax Revenue		Total Expenditure		
	1990-94	1995-00	1990-94	1995-00	1992-94	1995-00	2000-01
Argentina	22.0	19.1	22.4	20.3	22.4	26.1	28.9
Brazil	40.2	26.3	37.0	29.0	28.8	38.4	38.8
Bulgaria	46.4	36.4	38.4	29.8	45.8	39.5	41.0
Chile	24.6	20.5	24.8	20.6	19.5	20.3	23.6
Columbia	-	-	-	-	22.9	14.9	19.7
India	19.4	14.9	18.8	14.5	26.1	25.6	28.2
Pakistan	-	-	-	-	25.1	23.4	21.8
Israel	41.3	34.4	44.5	36.9	-	-	-
Malaysia	33.0	20.9	28.2	20.0	29.5	25.7	29.2
Romania	36.6	32.4	31.2	27.4	36.8	34.6	34.6
Russia	35.6	32.2	33.8	30.0	49.0	39.9	33.4
South Africa	28.5	24.8	30.1	26.2	36.8	31.0	27.9
Thailand	19.4	17.6	19.8	17.3	15.8	17.9	18.1
Indonesia	-	-	-	-	17.1	16.7	24.4

Source: Various Issues of Government Finance Statistics, IMF

On the other hand, general government expenditure as a percentage of GDP is roughly in line with international standards. This observation remains valid even for the period following Asian crisis, when many of the affected countries conducted expansionary fiscal policies to support the recovery.

