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Levels and Composition of Public Social and Economic Expenditures in India, 1950-51 to 2005-06

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Executive Summary

This paper is concerned with analysing changes in the levels and composition of spending by the state in India on the social and economic sectors. This analysis is undertaken for the Central government and the State (provincial) governments separately. The "functional classification" of expenditures in the budget documents is used as the basis for the analysis. While the broad period of analysis in the paper is 1950-51 to 2005-06, there would be special emphasis on understanding changes in expenditure patterns in the 1990s and 2000s.

The centrality of the role of the government in fulfilling the basic needs of people has been well argued in the literature. The phenomenon of "market failures" has come to be recognised almost universally. In developing countries, given the incompleteness, and often absence, of markets in a large number of spheres and the pervasiveness of information asymmetry, the role of the government becomes even more crucial. Studies have shown that the level of public expenditure on the social sectors is significantly associated with improvements in human development. Given the importance of public spending for human development indicators, the recent policy emphasis on fiscal adjustment has led to concerns that levels of pro-poor spending may be cut.

It is in this context that the present study attempted to analyse the levels and composition of government expenditure in India. An important concern raised by many development economists during the implementation of economic reforms in India was that the fiscal adjustment strategy may adversely affect the social sector expenditures. It was argued that the single-minded emphasis on reducing budget deficits may result in the relative reduction of expenditures in the 'soft" sectors.

The major questions that I ask in this paper are as follows:

1. What have been the trends in the *levels* of social and economic expenditures by the Centre and States?

2. What have been the changes in the *composition* of social and economic expenditures by the Centre and States?

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3. Has public expenditure in social and economic sectors shrunk in the period of fiscal adjustment in the 1990s and 2000s?

The results of this paper show that, overall, the fears of expenditure decline raised by scholars were largely real. A long run outcome of the fiscal policy in India was the inability of the state to raise tax collections towards meeting expenditure requirements. In the 1980s, the expenditure by the government in India had increased significantly, as a share of the GDP, in a large number of anti-poverty programmes and employment-creating activities. As these higher levels of expenditures were financed out of borrowings, the debt-GDP ratio of the government rose sharply. A fiscal crisis followed, which led to a fiscal adjustment policy from 1992 onwards. The fiscal crisis was most severe for the central government. The fiscal crisis of the Centre adversely affected the transfer of statutory funds to the States; the transfers from the Centre to the States declined in the 1990s. In addition, the deregulation of interest rates after 1991 led to a sharp rise in the interest rates that States had to pay, which led to a sharp rise in the debt burden of States. In sum, the finances of the States also entered into a period of crisis by the early-1990s.

In India, while the expenditure stance of the Centre has greater influence on the generation of aggregate demand, the expenditure stance of the States is more critical in the financing of social sector schemes. About 85 percent of all the expenditure in the social services is met by the State governments.

The response of the state in India to the fiscal crisis has been to go in for strict fiscal control measures, including a legally set ceiling on budget deficits through fiscal responsibility legislations. Our results show that the public expenditure of the central government declined sharply in the 1990s and 2000s, as compared to the 1980s. While there was some increase in the share of social sector expenditures and human priority expenditures as a share of the total expenditure, three important qualifications may be in order. First, as we tried to show, real per capita expenditure on human priority areas actually slowed down in the 1990s and 2000s relative to the 1980s. Secondly, in the framework of a slowdown in public expenditure as a whole, rising shares may mean little absolute increase in spending and rising growth rates may be unsustainable. Thirdly, on the ground, these moderate increases in expenditure by the centre have mattered little because most of the expenditure is through the State governments.

For the State governments, the conclusions that emerge are at variance with those of the Centre. The total expenditures by the States as a share of the GDP rose in the 1990s and early-2000s, but this rise was primarily to finance non-developmental expenditures like interest payments. Within total expenditure, the share that went into developmental expenditure declined in the 1990s and 2000s. Developmental expenditure as a share of the GDP also fell in the same period. In the case of social sector expenditures and human priority expenditures by States (the sphere where majority of the social sector expenditure took place), there were unambiguous falls relative to GDP and total expenditure. Within specific sub-sectors like education and health too, this relative decline in expenditure was visible.

Expenditure by the government on social and economic services is a crucial necessity for fulfilling the basic needs of people in developing countries. In India, this democratic function of the government would appear to face a serious threat from the nature of fiscal crisis that has developed. A transcending of this fiscal crisis is critical to liberating the government from constraints in spending, and reducing the social costs of spending cuts. However, to transcend the present fiscal crisis, a progressive transformation of the nature of fiscal policy would be required.

Introduction

The centrality of the role of the government in fulfilling the basic needs of people has been well argued in the literature. Over the years, the *laissez-faire* view of the role of government – that economic affairs of the society are best guided by decisions of individuals and not by a collective authority – has undergone severe criticism and revision even within the mainstream literature. Alongside, there has emerged a more sober view of the role of government. The phenomenon of "market failures" has come to be recognised almost universally. In theoretical terms, it is now accepted that the equilibrium attained in a free market need not be Pareto-optimal, and certain goods may not be provided at the equilibrium in socially optimal or desirable levels.

The need for government intervention due to market failures may arise in a large number of situations. *First*, in cases of "public goods", where the goods are non-rival and non-excludable in consumption, the seller would be unable to ensure that only those who purchased the good would be able to consume it (Samuelson, 1954). The charging of a price for such a good would be Pareto-inefficient. An additional unit of consumption provides benefit to the consumer without imposing an additional cost, and when a price is actually charged, some consumption is prevented resulting in a net loss of aggregate welfare. Thus, the issue of providing public goods becomes a matter of collective choice, and the government has to step in to provide these goods to the people. *Secondly*, in the presence of positive externalities, which may arise due to the non-existence of markets (say, when property rights are poorly defined); laissez-faire may lead only to the production of sub-optimal quantities of the commodity. Here, the only solution may be for the government to step in and compensate (Lerner, 1962).[2] *Thirdly*, in cases where there are increasing returns to scale, firms would be unable to equate prices with marginal costs. Hence, the actual output would be below the potential output, and government intervention may be essential in order to extract the true costs and benefits of production. *Fourthly*, the presence of incomplete information in exchanges can lead to problems of moral hazard and adverse selection. Here, the primary problem is that complete information about one party in the exchange is not available to the other, leading to socially suboptimal levels of provision of goods (Stiglitz, 1987; Akerlof, 1970). Here again, the role of the government in removing asymmetries in information flow becomes important, and in many cases, this may be possible only through public provision (Holmstrom, 1984).

In developing countries, given the incompleteness, and often absence, of markets in a large number of spheres and the pervasiveness of information asymmetry, the role of the government becomes even more crucial (Stiglitz, 1996). One of the important indicators of government involvement in the economy is the nature of its fiscal policy. Fiscal policy encompasses both resource mobilisation and expenditure strategies. While an analysis of the role of government should include both, a study of expenditure strategies has the advantage that one can analyse the directions of flow of public funds in the economy. It becomes possible to understand the prioritisation of expenditures by the government, as well as the factors that would influence changing priorities over time. For instance, one can attempt to study the extent to which government has intervened in human priority sectors like education and health, as compared to sectors like defence. The present paper is an attempt to study the

[2] The Coase theorem, which argued that there could be gains from trade even when markets are not present, has been critiqued because it assumes away transaction costs in bargaining, incompleteness of information and possibilities of free riding (see Coase, 1960). That is, markets do not arise automatically whenever there is a need for them.

changing role of the government in India with respect to the priorities in its expenditure strategies.

Of course, the study of public expenditure strategies is incomplete without a discussion on the political economy of fiscal policy (see O'Connor, 1973; Block, 1981).[3] Studies of this variety have argued that it is the political stance of the state that has often determined its commitment to expenditures in social and economic sectors. However, before one discusses the political economy of public expenditure, it is necessary to understand the levels and composition, as well as changes in the levels and composition, of public expenditures. The current study is a limited attempt at the latter.

Studies have shown that the level of public expenditure on the social sectors is significantly associated with improvements in human development. Of course, a one-to-one relationship between social spending and indicators of human development is difficult to make. However, higher levels of public expenditure on the social sectors do denote a particular "public policy stance", as Chakraborty (2003, p. 2) puts it, and public expenditure can be used as a good proxy to measure it.

In a recent study using panel data from 120 developing countries between 1975 and 2000, Baldacci *et al* (2004) argued that public spending in education and health had "a positive and significant direct impact on the accumulation of education and health capital" (p. 28). They argued that "an increase in education spending of 1 percentage point of GDP is associated with 3 more years of schooling on average…Similarly, an increase in health spending of 1 percentage point of GDP is associated with an increase of 0.6 percentage points in the under-5 child survival rate…" (*ibid*.). These positive impacts were strongest in the case of low-income countries and countries from Africa. In their widely-cited study of 22 countries, Anand and Ravallion (1993) argued that the effect on life expectancy rates of an increase in public spending on health was twice as significant as an increase in per capita income. They concluded that "certain components of public spending can matter greatly in enhancing human development in poor countries, and that they matter quite independently of what they do or don't deliver in terms of reduced income poverty" (p. 147). Chakraborty's (2003) analysis for selected developed and developing countries showed that "public spending on education and health has a stronger impact on human development than the growth of per capita income". A number of other studies have reached similar conclusions in varying degrees (see Psacharopoulos, 1994; Bhalla and Gill, 1991; Hojman, 1996; Bidani and Ravallion, 1997; Psacharopoulos and Patrinos, 2002).

Given the importance of public spending for human development indicators, the recent policy emphasis on fiscal adjustment has led to concerns that levels of pro-poor spending may be cut. Fiscal adjustment has been at the heart of the policies of stabilisation and structural adjustment in developing countries since the 1980s. According to Ebel (1991), "the rapidly changing economic environment of the 1980s characterised by government debt obligations has left governments scrambling to juggle budgetary priorities…In the majority [of countries], the share of social sector expenditure has been squeezed by higher priority debt servicing requirements" (p. 11-12). An early study in this regard by Cornia (1987) had shown that out of 78 countries that were implementing IMF-guided structural adjustment reforms, 91 percent had put a constraint on government expenditure, 83 percent had reduced the

[3] As O'Connor (1973) argued, "the volume and composition of government expenditures and the distribution of the tax burden are not determined by the laws of the market, but rather reflect and are structurally determined by social and economic conflicts between classes and groups" (p. 2).

budget deficits and 65 percent followed a policy of wage restraint. Studies have also noted strong associations between reduction in social sector expenditures and social indicators. In a cross-country analysis with respect to education, Rose (1995) found that

> In countries that have undertaken World Bank-supported adjustment programmes, a slow-down in the increase in average female combined first- and second-level gross school enrolment rates is observed between the pre-adjustment and adjustment phase. Furthermore, there has been an absolute decline in female enrolment rates in a number of adjusting countries over this period. The gap between male and female enrolment rates has narrowed on average for ... countries that have undertaken adjustment programmes and for the control group that have not. For the adjusting group of countries, however, the closing of the gender gap is due to the average male enrolment rate falling toward the lower average female enrolment rate, whereas for the non-adjusting group of countries the gap has narrowed due to an increase in the averages of both male and female enrolment rates (Rose 1995, p. 1931, cited in Ramachandran, 1997).

A country case studied in detail in this regard is that of Mexico. In the post-peso crisis years of the 1980s, the Mexican economy was subjected to stabilisation and structural adjustment measures under the advice of the IMF. Between 1983 and 1988, social expenditure (85 percent of which went to education and health) in Mexico fell by 33.1 percent; the expenditure on education alone fell by 29.6 percent (Lustig, 1992; see also Morley, 1995). According to Stewart (1995), between 1981 and 1988, educational spending per student fell by 41 percent, and real state spending on primary education fell by 49.3 percent. According to Appendini (1992, p. 3), through the 1980s, "the social costs of the adjustment and stabilisation programmes became dramatic". Stewart (1995) notes that

> The growth in primary and secondary enrolment rates fell sharply in the 1980s, compared with the 1970s; gross primary school enrolment rates fell from 1980-85 rising subsequently, while secondary ratios stagnated. The rate of primary school desertion in the rural areas rose from 7.2 percent to 12.2 percent, 1981-85, the worst period of the recession. There was a fall in the percentage of students continuing from the first stage of education to the next with primary to secondary absorption falling from 86.8 to 82.2 percent, 1981-88…Indicators suggest a decline in educational quality (Stewart, 1995, p. 203).

In this context, the evidence on the levels and composition of government expenditure from India would be interesting. India had, in 1991-92, entered into a programme of fiscal adjustment, which continues to guide economic policy thinking. From 1991 onwards, concerns have been raised by scholars on the impact of the new policies on public expenditure in the social sectors. The present paper attempts also to analyse changes in the *levels* and *composition* of public expenditure in India over the period of fiscal adjustment in the 1990s and after.

In India's federal system of governance, the responsibility of public spending falls not just on the Centre, but also on the States. Under the Indian Constitution, government responsibilities are divided into three lists: Central list, State list and the Concurrent list. Thus, any analysis of public expenditures has to take into account both Central and State expenditures. There have been some earlier studies on this topic, but these have been for shorter periods and for specific sectors (see Guhan, 1995; Prabhu, 1997; Mahendra Dev and Mooij, 2002; Mohan, 2005; ERF, 2006).[4] In this study, I use data on public expenditure of both Centre and the

[4] A useful study on public expenditure trends in India is Mundle and Rao (1997), but the last year of analysis here is 1992-93.

States on different social and economic sectors over a longer period than the available studies.

The major questions that I ask in this paper are as follows:

1. What have been the trends in the *levels* of social and economic expenditures by the Centre and States?

2. What have been the changes in the *composition* of social and economic expenditures by the Centre and States?

3. Has public expenditure in social and economic sectors shrunk in the period of fiscal adjustment in the 1990s and 2000s?

II The Data Base and Methodology

The data used in this paper have been taken mainly from different publications of the Ministry of Finance (MoF) and the Reserve Bank of India (RBI). For data on the finances of the Centre, I have relied on two sources: Chandhok (1990) for information between 1950-51 and 1988-89 and various issues of MoF's *Indian Public Finance Statistics* for information between 1989-90 and 2005-06. For data on the finances of the States, I have relied completely on the publications of the RBI. Information until 1999-00 was collected from the annual reviews on State finances published in the *RBI Bulletin*. From 2000-01 onwards, the RBI began publishing a separate annual report on State finances, titled *State Finances: A Study of Budgets*. Data for the years after 2000-01 are taken from various issues of this report.

I have used the GDP deflator and the SDP deflator for deflating the time series on expenditures. The GDP deflator (base year 1999-00) has been used for deflating the expenditure series of the Centre and all States. The respective SDP deflators (base year 1980-81) have been used to deflate the expenditure series for States. The GDP and SDP data were collected from various issues of the RBI's "Handbook of Statistics on the Indian Economy".

While collecting data on expenditures, I have primarily focussed on the *functional classification* of expenditures of the government. The functional classification is a detailed classification of the functions that government units aim to achieve through various kinds of outlays. The use of this classification permits a study of inter-temporal trends in government outlays on particular functions.

There have been major changes in the way the functional classification has been published between 1950-51 and 2005-06. For instance, the expenditure classification under Social Services and Economic services is available only after 1973-74, and data prior to 1973-74 are available only under two broad heads: developmental and non-developmental expenditures. As a result, the analysis of social and economic expenditures by the Centre in this paper begins only from 1973-74. However, expenditure on certain sub-sectors (such as education) are available from 1950-51 onwards; for such series, the analysis in this paper covers the period between 1950-51 and 2005-06.

There has always been a controversy over what items of expenditure should be classified under revenue expenditure and capital expenditure. Steering clear of this controversy, this paper uses only total expenditure (revenue *plus* capital) for both the Centre and the States.

An analysis of expenditures of the government has to be undertaken at many levels. First, one has to analyse the absolute *levels* of expenditures. Such an analysis has been attempted in this paper using growth rates of per capita real expenditures in each sector. Secondly, this paper attempts to analyse changes in the size of expenditure in each sector *relative* to the size of economy as well as to the size of total expenditure. Here, I have tried to compute the expenditure in each sector as a share of GDP/SDP as well as total expenditures. Following the analysis in the UNDP's *Human Development Report 1991*, this paper uses four ratios to analyse changes in social expenditure patterns. They are:

(a) *Public Expenditure Ratio* (PER): the percentage of national income (GDP) that goes into public expenditure;

(b) *Social Allocation Ratio* (SAR): the share of public expenditure earmarked for the social sector;

(c) *Social Priority Ratio* (SPR): the share of social sector expenditure earmarked for human priority areas;

(d) *Human Expenditure Ratio* (HER): the share of national income (GDP) devoted to human priority areas.

It must be obvious that the HER is obtained as the product of PER, SAR and SPR. In this paper, social sector expenditures are defined as the sum of revenue and capital expenditures on Social Services and Rural Development.[5] For the Centre, social services are defined as (1) all items in "Social and Community Services" (except Scientific Services and Research, Broadcasting and Information and Publicity) and (2) "Social Security and Welfare" (that comes under non-developmental expenditure). Thus, the items of expenditure included under Social and Community Services are (a) Education, Arts and Culture; (b) Medical, Public Health, Sanitation and Water supply; (c) Family Welfare; (d) Housing; (e) Urban Development; (f) Labour and Employment; and (g) Social Security and Welfare (plan). In a slight deviation from the UNDP definition, I have defined human priority areas in this paper as the items of (i) Education; (ii) Medical, Public Health, Sanitation and Water supply; (iii) Family Welfare; and (iv) Rural Development.[6]

For the State governments, social sector is defined as all items under Social Services and Rural Development. Social Services, thus, include (a) Education, Sports, Art and culture; (b) Medical and Public Health; (c) Family Welfare; (d) Water Supply and Sanitation; (e) Housing; (f) Urban Development; (g) Welfare of Scheduled Castes, Scheduled Tribes and

[5] Social services expenditure is that expenditure used for providing basic amenities for citizens as consumers. On the other hand, Economic Services expenditure promotes productive activities in the economy (Shariff, Ghosh and Mondal, 2002).

[6] As per the UNDP definition, the human priority areas are defined as to comprise elementary education, health and family welfare (excluding medical education, training and research), nutrition, water supply and sanitation and rural development. Data on these sub-categories are not compiled for all States together; they are available only from the State-level budget documents, which were not available to me. Hence, to ensure comparability between the analysis at the central and State levels, I decided to use the modified and broader definition of priority areas for the centre as well.

Other Backward Castes; (h) Labour and Labour Welfare; (i) Social Security and Welfare; (j) Nutrition; (k) Relief on account of Natural Calamities; and (l) Other Social Services. Again, in a deviation from the UNDP definition, I have defined human priority areas in this paper as the items of (i) Education, Arts and Culture; (ii) Medical and Public Health; (iii) Family Welfare; (iv) Nutrition; (v) Water Supply and Sanitation; and (vi) Rural Development.[7]

III Analysis of Expenditures – Central Government

In this sub-section, I discuss trends in the levels and composition of public expenditure for the central government. I shall structure the discussion in terms of the different ratios that we have outlined in Section 2.

Public Expenditure and Developmental Expenditure

In 1950-51, the total expenditure of the Centre as a share of the GDP (the PER) stood at 5.1 percent (Figure 1). After 1950-51, the PER increased steadily and reached 14.4 percent in 1966-67.[8] There was a fall in the PER after the mid-sixties, and this fall was not reversed until the mid-seventies. The PER began to rise after 1973-74, grew at a very rapid pace between 1983-84 and 1986-87, and reached its peak value of 19.2 percent in 1986-87. The period after 1986-87, particularly the years in the 1990s, saw a very sharp fall in the PER. In 2005-06, the PER was 12.9 percent, which was the same as the PER in 1977-78.

Significantly, levels of total developmental expenditure (TDE) follow a trend similar to that of total public expenditure. The share of TDE in the GDP rose after 1973-74 and reached its peak values in the late-1980s. In 1989-90, the share of TDE in GDP was 6.7 percent. In the 1990s and 2000s, the share of TDE in GDP fell sharply; in 2005-06, the share of TDE in GDP was 4.6 percent, which was comparable to the level attained in 1978-79. Thus, while there was a rise in the share of public expenditure and TDE in the GDP after the mid-seventies until the mid-eighties, the trend was significantly reversed in the 1990s. It has been argued elsewhere that the shrinking of public expenditure and developmental expenditure in the 1990s contributed significantly to deflationary trends in the Indian economy (Chandrasekhar and Ghosh, 2002).

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[7] See previous footnote for an explanation on the definition.

[8] Studies have linked the sharp rise in public expenditure in the years after independence to the strategy of *dirigisme*, or "national capital accumulation by…state action", adopted by the state in India (see Toye, 1981). Reddy (1972) noted that trends in public expenditure after independence "marked a distinct break with the past" (p. 141). According to Toye, The links between *dirigistic* development and public expenditure are conceivably several. But in India they took a concrete form, which may be termed the policy of state accumulation…Public expenditure is necessarily one of the major policy instruments that regulate the rate of state accumulation (1981, p. 10).

Figure 1 Public Expenditure Ratio and Share of Total Development Expenditure in GDP of the Centre, Revenue and Capital, 1950-51 to 2005-06, in per cent

Table 1 provides period-wise growth rates of per capita expenditure of the Centre under selected heads between 1960-61 and 2005-06. The periodisation adopted in this paper has been designed to capture shifts in growth rates across different policy regimes (for instance, the 1980s were a period of fiscal expansion and the 1990s a period of fiscal adjustment) as well as to reflect short-term improvements or declines in the recent periods (for instance, the 2000s). The growth rate of per capita developmental expenditure was negative in the 1960s, primarily owing to the absolute fall in its levels after the mid-sixties. Following a rise in the levels after 1973-74, per capita developmental expenditure grew at about 6 percent per annum in the 1970s and 1980s. However, the growth rate fell to negative levels in the 1990s, even while the per capita GDP growth rate was higher than in the 1970s and 1980s. The growth rate recovered in the 2000s, mainly owing to a rise in its levels in the three years after 2002-03.

Table 1: ***Compound annual growth rates of per capita expenditure of the Central government under selected heads, revenue and capital, 1960-61 to 2005-06,*** **in percent per annum**

Item	1960-61 to 1969-70	1970-71 to 1979-80	1980-81 to 1989-90	1990-91 to 1999-00	2000-01 to 2005-06
1. Developmental expenditure	**-1.6**	**6.0**	**6.1**	**-0.7**	**7.6**
(a) Social and Community Services*	-	5.4	11.8	9.0	9.1
Education, Art and Culture	-2.4	2.6	13.1	4.9	9.9
Medical, Public Health, Sanitation and Water supply*	-	7.7	5.1	5.4	8.2
Family welfare*	-	-1.5	7.4	3.5	5.5
Housing*	-	19.4	0.5	21.3	3.4
(b) Agriculture and Allied Services*	-	-3.9	6.6	6.6	9.3
2. Non-Developmental expenditure	**7.4**	**1.9**	**8.2**	**4.3**	**2.4**
3. Total Expenditure	**0.7**	**4.8**	**6.6**	**1.4**	**2.4**
4. Per Capita GDP at constant prices	1.3	1.1	3.2	3.8	5.2

Source: Computed from data in Chandhok (1990) and various issues of *Indian Public Finance Statistics*, Ministry of Finance.
Notes: * denotes that the growth rates for Period 2 are from 1974-75 to 1979-80.

It would be, however, premature to read the rise in the growth of per capita developmental expenditure in the 2000s as a reversal of the trends in the 1990s. First, the high growth rate of the 2000s represents a growth over a negative growth rate in the 1990s. Secondly, the growth rate of per capita *total* expenditure rose at only 2.4 percent per annum in the 2000s, which was only slightly higher than the corresponding growth rate for the 1990s (1.4 percent) and significantly lower than the corresponding growth rate for the 1980s (6.6 percent). A real and sustained expansion of per capita developmental expenditure would be feasible only under the scenario of growing per capita total expenditure. In a scenario where the total expenditure grows only slowly, the increase in developmental expenditure is certain to hit a ceiling very soon.

In this context, it may be instructive to look at how the shares of major sub-heads of expenditures within total expenditure have changed in the period of analysis. As Table 2 shows, the share of developmental expenditure increased from 31.3 percent in 1974-75 to 36.9 percent in 1985-86. After 1985-86, there was a significant fall in the share of developmental expenditure through the 1990s. There was a recovery in the share of developmental expenditure in the 2000s, but the share in 2005-06 remained lower than the corresponding share for the mid-eighties.

An important factor that has been constraining the growth of developmental expenditures is the rising share of non-developmental expenditures. The share of non-developmental expenditures of the Centre grew from 44.5 percent in 1985-86 to 59.3 percent in 1995-96 and 63.9 percent in 2000-01 (see Table 2). Within non-developmental expenditure, the item that has grown the fastest is the share of interest payments. Interest payments increased from 14.9 percent in 1985-86 to 28.7 percent in 1995-96 and 31.7 percent in 2000-01. While interest payments have fallen in share in the first half of the 2000s, they continue to remain very large, constituting about one-fourth of the total expenditure in 2005-06 (see below for a detailed discussion). The share of total expenditure spent on administrative services and pensions has risen in the 1990s, contributing to the increase in non-developmental expenditure.

Social Sector Expenditure and Social Allocation Ratio

Social sector expenditure (SSE) is defined as the sum of expenditures on social services and rural development. It must be noted here that what is more important with respect to social services expenditure is the expenditure by the State governments, and not the central government. Given the division of responsibilities between the Centre and the States in India, on an average, only about 15 percent of the spending in social services is undertaken by the central government (CBGA, 2006). In a sector like education, the share of Centre's expenditure in total expenditure was only 11 percent in 1999-00 (Shariff, Ghosh and Mondal, 2002). Thus, trends in SSE of the Centre should not lead us to a generalised understanding of change in expenditure patterns in the country as a whole.

The share of SSE by the Centre in the GDP, after remaining stagnant for a long period, began to rise in the mid-1980s and then fell for a short period in the beginning of the 1990s (Figure 2). Between 1992-93 and 1995-96, the SSE increased marginally from 0.8 percent of GDP to 1.3 percent of the GDP. Thereafter, the SSE as a share of the GDP remained almost stagnant; in 2005-06, the corresponding share was 1.5 percent.

As a share of the total expenditure (TE), however, SSE shows different trends. After a period of stagnation, the share of SSE in TE rose significantly between 1984-85 and 1989-90 (Figure 2). In 1989-90, the share of SSE in TE was 7.8 percent. In the beginning of the 1990s, there was a sharp fall in the share of SSE in TE, which later recovered to reach 8.7 percent in 1995-96. Between 1995-96 and 2001-02, the share of SSE in TE declined from 8.7 percent to 7.9 percent. Between 2001-02 and 2005-06, the share of SSE in TE increased again to reach 10.8 percent in 2005-06.

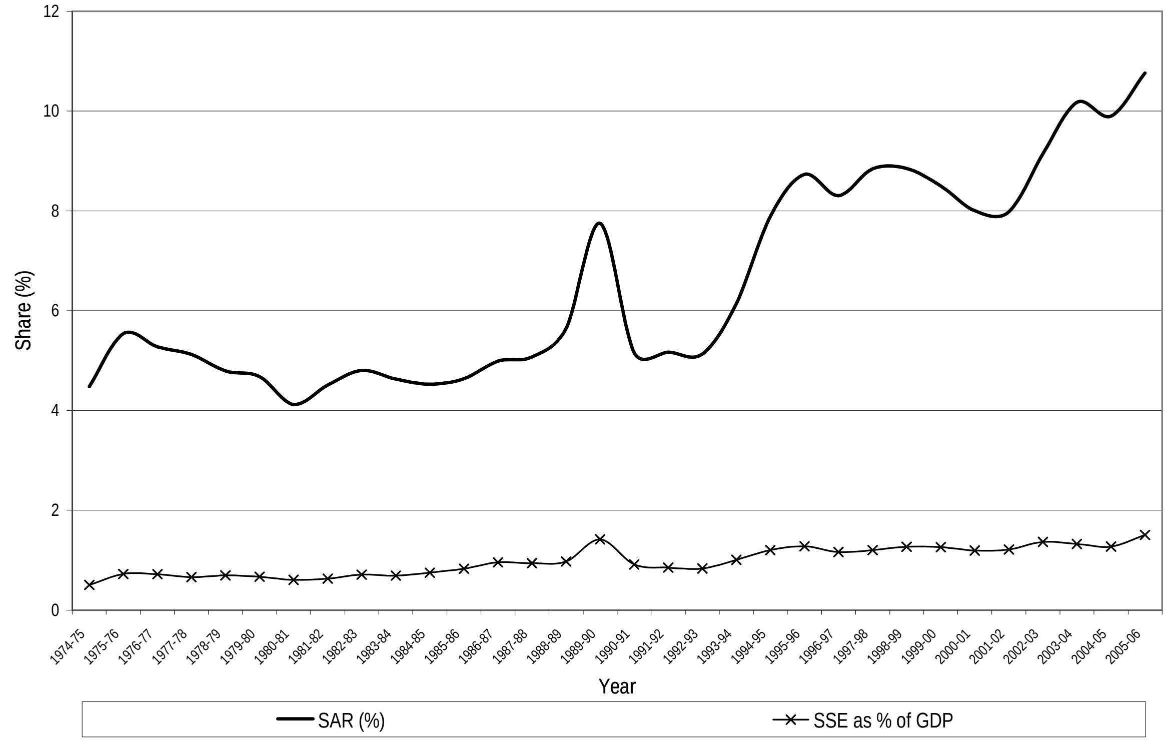
Thus, while the share of SSE in the GDP remained almost stagnant through the 1990s and 2000s, the share of SSE in TE increased. If one considers the endpoints, the share of SSE in TE was 5.2 percent in 1990-91, 8 percent in 2000-01 and 10.8 percent in 2005-06. However, this rise in the share of SSE in TE in the 1990s and 2000s does not represent any significant rise of SSE in its absolutes. As the total expenditure itself was growing very slowly, this increase of SSE as a share of TE meant little; as Table 1 shows, the growth rate of social services within SSE in the 1990s and 2000s was actually lower than its growth rate in the 1980s.

Table 2: ***Share of selected heads of expenditures in total expenditure of the Central government, revenue and capital, 74-75 to 05-06*, in per cent**

Item	1974-75	1980-81	1985-86	1990-91	1995-96	2000-01	2005-06
1. Developmental expenditure	**31.3**	**35.4**	**36.9**	**34.3**	**27.4**	**29.2**	**35.7**
(a) Social and Community Services	5.8	5.3	6.2	6.4	6.8	8.0	9.3
(i) Education, Art and Culture	1.8	1.5	1.6	2.2	2.2	2.8	3.7
(ii) Medical, Public Health, Sanitation and Water supply	0.8	0.8	0.7	0.7	0.9	1.0	1.2
(iii) Family welfare	0.7	0.6	1.0	0.8	0.9	1.0	1.1
(iv) Housing	0.3	0.4	0.3	0.2	0.4	0.8	0.7
(b) General Economic Services	1.0	2.5	1.7	4.0	-0.2	0.4	6.5
(c) Agriculture and Allied Services	5.6	3.2	2.3	3.2	5.2	4.1	5.8
2. Non-Developmental expenditure	**47.3**	**43.7**	**44.5**	**48.5**	**59.3**	**63.9**	**59.3**
(a) Interest payments	11.4	12.2	14.9	21.3	28.7	31.7	26.1
(b) Defense services	24.1	18.1	16.9	15.3	15.4	15.9	16.4
(c) Administrative services	3.7	2.7	2.3	2.8	3.5	4.3	4.1
(d) Pension, other retirement benefits	0.2	0.3	0.4	2.1	2.5	4.5	4.1
3. Other expenditures	**21.4**	**20.9**	**18.6**	**17.2**	**13.3**	**7.0**	**5.0**
4. Total Expenditure	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Computed from data in Chandhok (1990) and various issues of *Indian Public Finance Statistics*, Ministry of Finance.

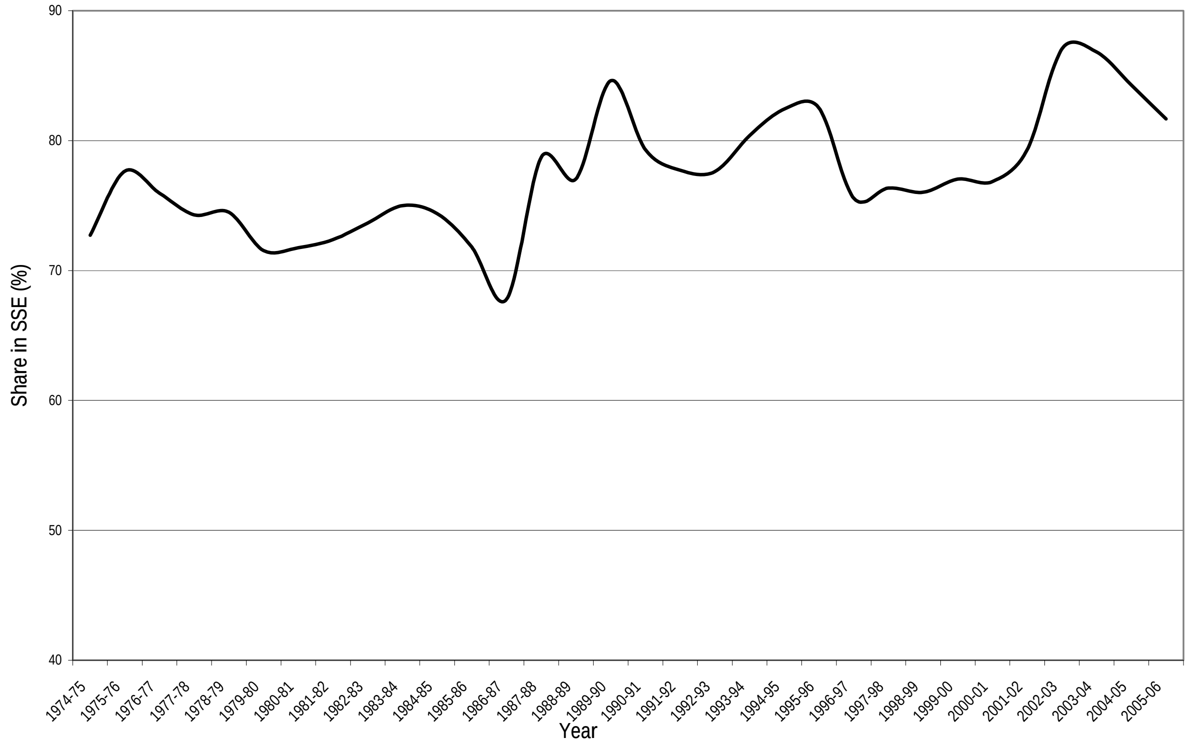
Figure 2 Social Allocation Ratio and Social Sector Expenditure as share of GDP, Centre, Revenue and Capital, 1974-75 to 2005-06, in per cent



Social Priority Ratio

As a share of the SSE, the expenditure devoted to Education, Medical, Public Health, Sanitation and Water supply, Family Welfare and Rural Development was defined as the Social Priority Ratio (SPR). The SPR of the Centre recorded a decline in the years between 1983-84 and 1986-87 (Figure 3). Between 1986-87 and 1989-90, the SPR rose sharply from 67.8 percent to 84.6 percent. The trends in SPR in the 1990s and 2000s could be described as fluctuating over a generally declining trend. Between 1989-90 and 2000-01, the SPR of the Centre declined from 84.6 percent to 76.7 percent. The trends of SPR in the 2000s appear to be fluctuating over a positive slope, but this rise was insufficient to take the levels of SPR back to the levels of 1989-90.

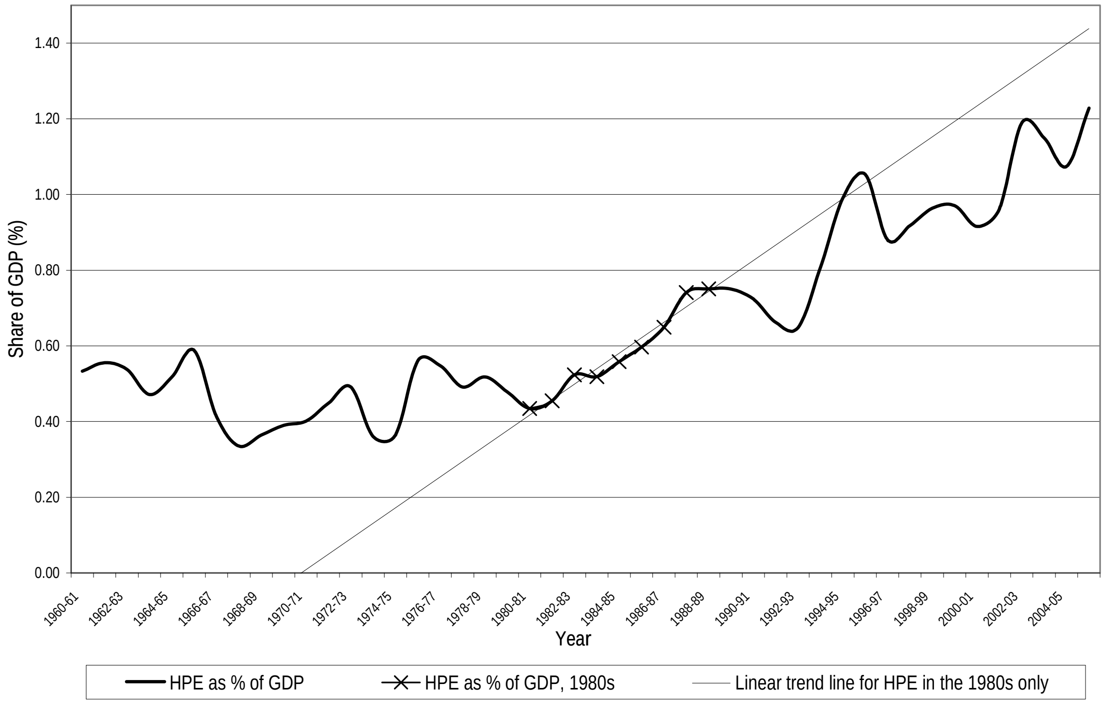
Figure 3 Social Priority Ratio of the Centre, as share in SSE, Revenue and Capital, 1974-75 to 2005-06, in per cent



Human Expenditure Ratio

The Human Expenditure Ratio (HER), as noted, is the share of expenditure in human priority areas expressed as a share of the GDP. The HER of the Centre, after fluctuating till the end of the 1970s, recorded an increase through the years of the 1980s (Figure 4). Between 1980-81 and 1988-89, the HER increased from 0.43 percent to 0.75 percent. However, after 1988-89, the HER increased at a much slower rate than in the 1980s. In addition, the changes in HER in the 1990s and 2000s fluctuated significantly around its slope. In Figure 4, I have plotted the trend line for the HER for the 1980s and then projected it forward until 2005-06. This trend line allows us to see what the HER would have been in 2005-06 had it continued to grow at the same growth rate as in the 1980s. As can be seen from the figure, in all the years of the 1990s and 2000s (but one), the HER was significantly below the trend line. In other words, the growth rate of the HER in the 1990s and 2000s was significantly lower than in the 1980s.

Figure 4 The Human Expenditure Ratio of the Centre and the Projected Trend Line for the 1980s, Revenue and Capital, 1960-61 to 2005-06, in per cent



We can delineate two broad reasons for the slow growth rate of HER in the 1990s and 2000s. First, *the total expenditure of the Centre – in a sense, the size of the pie – had grown in the 1990s and 2000s at a rate significantly slower than in the 1980s*. As a result, even when certain sub-sectors recorded increase in shares of expenditures to total, the levels of absolute increase in expenditures would have been smaller. Secondly, the composition of SSE appears to have moved away from the human priority areas in the 1990s. As a result, the growth of expenditure on human priority areas by the centre slowed down, leading to a slowdown in HER.

Sector-wise expenditures as a share of the GDP

If we consider each important sub-sector within developmental expenditure, and analyse changes in their levels of expenditure as a share of the GDP, the following broad conclusions emerge (see Figure Panel 5).

(a) Education, Arts and Culture: Until 1983-84, the share of expenditure by the Centre on education, arts and culture in the GDP does not show any specific trend (Figure Panel 5). Between 1983-84 and 1988-89, the share more than doubled from 0.23 percent to 0.48 percent. The share fell after 1988-89 to reach 0.3 percent in 1996-97. After 1996-97, there was an increase in the share of expenditure on education; this increase was owing to the introduction of the Mid Day Meal Scheme in schools and the new World Bank-funded District Primary Education Programme (DPEP). However, until 2005-06, the share of educational expenditure in GDP did not rise above the corresponding share attained in 1988-89. The increase in educational expenditure in the two years from 2004-05 was due to the fact that the government introduced an educational cess in order to be exclusively invested in the Sarva Siksha Abhiyan (SSA) and the Mid Day Meal Scheme. As a result of the investment of this cess, the share of expenditure increased from 0.41 percent in 2003-04 to 0.52 percent in 2005-06. The point to note here is that the sharp and prolonged fall in the share of

expenditure on education in the 1990s delayed the step up in educational expenditure by nearly a decade.

(b) Medical, Public Health, Sanitation and Water Supply and Family Welfare: Broadly speaking, the above areas could be classified as expenditures on “health”. The share of expenditure on health, thus classified, in the GDP recorded a rise from 0.2 percent in 1980-81 to 0.31 percent in 1986-87. Between 1986-87 and 1996-97, the share fell sharply; in 1996-97, the share of health expenditure in the GDP was 0.23 percent. Even though the share rose after 1996-97, it was not until 2002-03 that it regained the share achieved in 1986-87. Within Health, the largest increase in expenditure took place for Reproductive and Child Health that is included under Family Welfare (Shariff, Ghosh and Mondal, 2002; Mahendra Dev and Mooij, 2002). After 2002-03, the share remained almost stagnant; in 2005-06, the share of expenditure by the Centre on health in the GDP was almost the same as in 1996-97, that is, 0.32 percent.

(c) Housing: The share of expenditure on housing in the GDP declined through the 1980s till 1993-94. Between 1993-94 and 1999-00, the share rose slightly from 0.05 percent to 0.14 percent. However, it is unclear if this rise was real, as from 1996-97 onwards the expenditure under the Indira Awas Yojana (IAY) began to be included under Housing, instead of Rural Development. Between 1999-00 and 2005-06, the share declined again; in 2005-06, the share of expenditure on housing in the GDP was 0.1 percent, which was almost the same share attained in the year 1996-97.

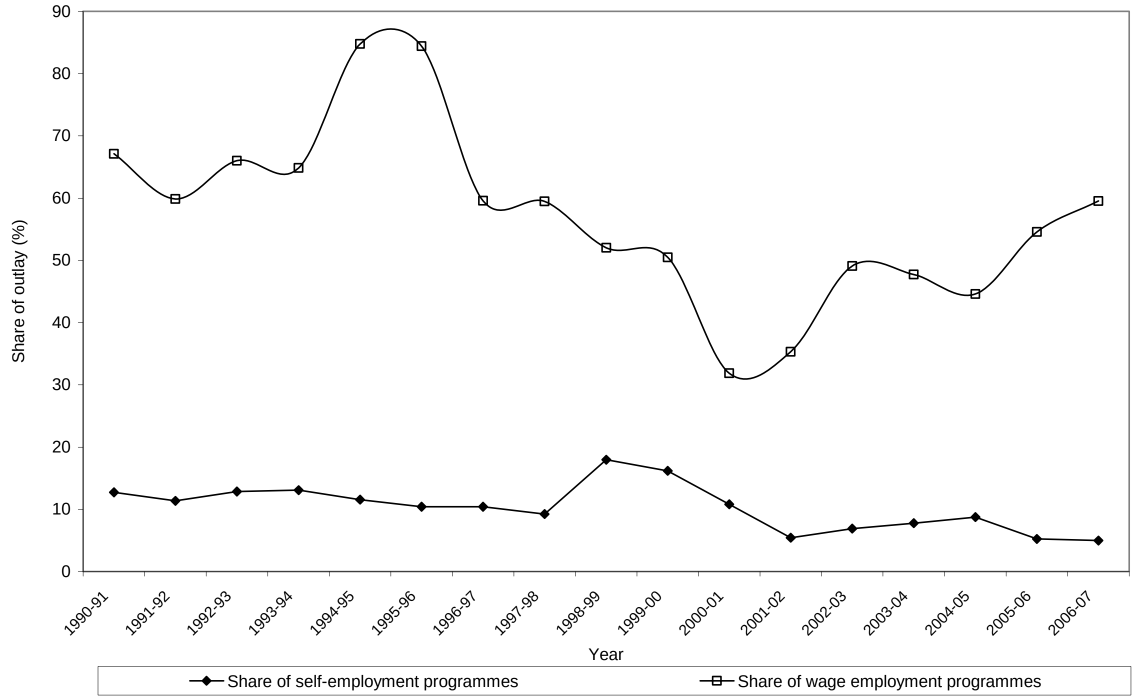
(d) In the sub-sectors of Urban Development, Labour and Employment and Water and Power Development, there was significant rise in the shares of expenditures in the GDP in the 1980s. However, in the 1990s, there was a fall in the shares of expenditures in the GDP in these sectors. In the case of Urban Development, the share recovered after 1995-96, but the share attained in 2005-06 was still lower than in 1990-91. In Labour and Employment, and Water and Power Development, there was no such recovery, and the fall in share continued into the 2000s.

(e) In Social Security and Welfare, there was a fall in the share of expenditure in the GDP from 1986-87 onwards. Even though there was a slight recovery for a few years in the mid-1990s, the share continued to fall after 1996-97.

(f) Agriculture and Allied Services: The share of expenditure on agriculture and allied services in the GDP recorded a fluctuating trend through the period of analysis. However, it could be concluded that after 1993-94, there were more number of years when the share of expenditure in GDP declined than when it increased. In 2005-06, the share of expenditure in the GDP was 0.81 percent. Rural Development is a separate head within Agriculture in the budgets. In Rural Development, which includes a large number of anti-poverty programmes in the rural areas, there was a major fall of expenditure as a share of GDP in the 1990s (Mundle and Rao, 1997). This fall was due to major cutbacks in the components of employment creation within Rural Development (see Figure 6). Also, in part, the fall was the result of the non-inclusion of expenditure under the Indira Awas Yojana (IAY) under Rural Development from the year 1996-97. The rise in expenditure noted in the 2000s was owing to 2 reasons: first, the introduction of the Pradhan Mantri Gram Sadak Yojana (PMGSY) in 1999-00; and secondly, the introduction of new schemes for wage- and self-employment creation (such as the Sampoorna Gramin Rozgar Yojana or SGRY and the Swarnajayanti

Gram Swarozgar Yojana or SGSRY) in the rural areas, both of which are included under Rural Development (Figure Panel 5).

Figure 6 Trends in the shares of budgetary outlays for wage-employment and self-employment programmes in the total outlay for the Ministry of Rural Development, 1990-91 to 2006-07, in per cent



(g) Transport and Communications: Here, the share of expenditure in the GDP recorded a falling trend between 1980-81 and 1996-97. After 1996-97, the share began to rise from 0.23 percent to reach 0.61 percent in 2005-06.

It could be concluded that *in many human priority sectors (such as Education and Health) as well as infrastructural sectors like Water and Power Development, there was a fall in the share of expenditure by the Centre to the GDP for fairly long stretches of years in the 1990s*. In almost all these sectors, the share of expenditure in the GDP had recorded a rise in the 1980s. While there was some recovery visible in the 2000s in sectors like Education, Health and Agriculture and Allied Services, there were largely insufficient to compensate for the sharp falls in the 1990s.

The Policy of Fiscal Compression and the Trends in Public Expenditure

The decline in the PER of the Centre in the 1990s and 2000s cannot simplistically be seen as an outcome of a rise in committed items of non-developmental expenditure. I would argue here that the decline in PER is a result of a carefully designed policy package in the 1990s, which included expenditure compression as its focus. I shall briefly elaborate here on the background to the emergence of such a package in the 1990s and its major features.

In the 1980s, economic policy in India was marked by a revival of GDP growth and industrial growth from the long period of stagnation from the mid-1960s. This revival of GDP growth originated from an expansionary programme of public expenditure, which is reflected in our results as a rise in the PER. First, significant government expenditure flowed into the rural areas due to the expansion in state-funded rural development programmes, particularly public works schemes and self-employment schemes. Secondly, the government played a more direct role in the expansion of employment.[9] Thirdly, the government invested significantly in rural infrastructure, particularly roads and transport (see Sen, 1998).

The problem with the economic strategy of the 1980s was that the increased government expenditure was funded largely through external borrowings, and not through different forms of domestic resource mobilisation like taxation. An increase in government expenditure funded by higher tax collection would have considerably reduced the debt burdens associated with this strategy. India historically has had one of the lowest tax-GDP ratios in the world.[10] Between the mid-1970s and late-1980s, the attained increase in the tax-GDP ratio of the Centre was hardly sufficient to finance the rising expenditure bill (see Table 3). As a result, the total liabilities of the Centre that averaged 43 percent of the GDP during 1981-85 rose to 53 percent during 1986-90 (see Table 3). The gross fiscal deficit increased from 5.9 percent during 1981-85 to 7.7 percent during 1986-90. This also represented a movement of Central government finances from a state of revenue surplus to revenue deficit, which averaged 2.4 percent during 1986-90. Given the dependence on external debt, combined with a host of other external reasons related to the Gulf War, the economy slowly walked into a balance of payments crisis, which became the background for the introduction of economic liberalisation policies by the then government in 1991.

Table 3: ***Selected fiscal indicators of the Central government, 1976 to 2005, as share in GDP*****, in percent**

Item	Shares in GDP (percent)					
	1976-80	1981-85	1986-90	1991-95	1996-00	2000-05
Gross tax revenue	9.3	9.4	10.5	9.7	9.0	8.9
Total liabilities	-	42.8	53.1	54.2	50.8	61.1
Interest payments	1.7	2.1	3.2	4.1	4.4	4.6
Gross fiscal deficit	4.4	5.9	7.7	6.3	5.5	5.2
Revenue deficit	-0.3	1.0	2.4	3.0	3.1	3.8

Source: "Handbook of Statistics on the Indian Economy", RBI, various issues.

There is one strand of the literature that argues that the debt-build up of the 1980s was "policy-induced". According to these authors, representing the monetarist school, the regulated interest rate regime in the 1980s was marked by "financial repression", which engendered the fiscal crisis of 1991.[11] Financial repression is a situation where the degree of financial intermediation is weak due to negative real rates of interest on deposits and a large spread between borrowing and lending rates. As a result, while private savings and investments are discouraged on the one hand, the government is encouraged to borrow and

9 NSS data show that among all people who gained government employment in the 1980s, about 60 percent were from the rural areas (Sen, 1998).

10 As the government's task force on the fiscal responsibility legislation put it, "one of the important reasons for the low tax/GDP ratio is the erosion of the tax base through a large number of exemptions. Such exemptions are fiscally identical to subsidies. That is, tax revenues foregone are no different from explicit subsidies paid out." (GoI, 2004, p. 24).

11 This argument was brought to my notice by the anonymous referee of this paper.

spend beyond its means by the low interest rate regime. A large part of this spending of the government in India, the argument goes, were in services where "cost recovery" was poor (Mundle and Rao, 1997). In other words, spending on "unproductive subsidies" added to the "unsustainability" of the fiscal policy.

To state in brief, the above argument stands on weak grounds. First, the theory behind the above argument assumes, among other things, that changes in money supply in an economy neither affect the real sector activities nor output growth and that money supply is exogenous to the system, which can be successfully controlled by the government. Both these assumptions have been subjected to serious criticism and rebuttal by economists studying the developing economies (Kaldor, 1978; Bhaduri, 1986; Patnaik, 1995). Secondly, to argue that financial system in India was underdeveloped and savings were discouraged in the period of financial repression does not stand up to facts. The unparalleled growth of the Indian financial system in India took place under the larger policy of financial repression (see Rakshit, 1988; Shetty, 2005). In fact, the work of Vijay Joshi and I. M. D. Little – two protagonists of economic reform in India – show that nationalisation of banks in 1969 was a major driver of financial intermediation in India. The share of deposits to GDP rose from 13 percent in 1969 to 38 percent in 1991 and the share of advances to GDP rose from 10 percent in 1969 to 25 percent in 1991 (Joshi and Little, 1998, p. 36). They noted that

> the *increasing degree of financial intermediation* was closely associated with the very rapid spread of commercial banking throughout the country after bank nationalisation in 1969…This spread has also surely contributed to the rapid rise in household financial savings and probably also to the rise in the overall rate of saving (p. 36)…*Financial repression was therefore mild* and any deleterious effects on savings were offset by the rapid spread of banking (Joshi and Little, 1998, p. 255; emphasis mine).

Thirdly, the argument that an expansion in subsidy outlays have resulted in fiscal stress also is based on questionable assumptions and methodology (see Chandrasekhar and Ghosh, 2002). Many of the subsidies in India are aimed at encouraging producers to adopt modern methods of production and to address market failures in sectors like food distribution. Even while private valuations of certain goods may vary from their societal value, such variations may be "socially desirable" (*ibid*., p. 75). Further, subsidies, including implicit subsidies, are ways of maintaining certain levels of aggregate economic activity under counter-cyclical demand management policies.

The crux of the critique presented here is that it would be erroneous to argue that financial repression and subsidies contributed to "unsustainable" spending in the 1980s leading to the fiscal crisis in 1991. It was indeed a policy failure that the results of carrying out expenditures under a lax tax regime were not anticipated. As we argued earlier, a vibrant and progressive tax regime could have considerably reduced the debt burdens associated with the spending strategy of the 1980s, even in the presence of financial repression and subsidies. With the rise in tax-GDP ratios not commensurate with the rise in spending, the crisis of 1991 was waiting to happen.

Fiscal consolidation was at the heart of the new package in 1991, aided by the IMF, of stabilisation and structural adjustment. The solution to the fiscal crisis of the state was sought not on the revenue side (by which a rise in tax collections would have at least partly financed the interest obligations) but on the expenditure side. A strict policy of fiscal control was followed in the early 1990s. Expenditure cuts were effected in the important social sectors as well as on capital expenditures.[12] In many social sectors that were starved for more funds, expenditures were not raised, which adversely affected the quality of these services. Thus, the fiscal deficit of the Centre was brought down to 6.3 percent during 1991-95 and 5.5 percent during 1999-00.

The array of associated policies that accompanied fiscal adjustment after 1991 further exacerbated the fiscal crisis (Chandrasekhar and Ghosh, 2002). As attracting FDI in competition with other developing countries became a policy objective, the rates of tax on FDI were reduced. Customs duties on a range of commodities were reduced as a part of the trade liberalisation policy. As financial liberalisation led to higher interest rates, the interest outgo of the government against borrowings went up, the larger interest burden that resulted was a direct result of abandoning financial repression. In the overall context of lower growth rates resulting from lower levels of public spending, all the above measures adversely affected the fiscal health of the central government.

In 2000, the Fiscal Responsibility and Budgetary Management (FRBM) Bill was introduced in the Parliament. The FRBM Act was passed by Parliament in 2003. In this version of the Act, the Government had to reduce the revenue deficit to zero by 2005-06. In July 2004, the Act was amended to postpone the year of elimination of revenue deficit to 2008-09. In the amended form, the Act stated that the governments should initiate ‘‘appropriate measures to reduce the fiscal deficit and revenue deficit so as to eliminate revenue deficit by 31st March 2008 and thereafter build up adequate revenue surplus”. Towards achieving this goal, the government was to set annual targets for fiscal and revenue deficits so that the final targets in 2008-09 could be met.

Thus, from the early 2000s, fiscal compression became a legally binding policy for the government. *The falling PER for the Centre from the early 1990s until 2005-06, which we noted in our discussion above, was a direct result of this fiscal compression.* Within the framework set by shrinking total expenditure in the 1990s and 2000s, there was a slowdown in the flow of funds to human priority areas relative to the size of the economy. As one study noted,

> …this decline [in allocations] is particularly conspicuous in terms of the structural adjustment and stabilisation policies of the government that seems to have ignored its commitment to sustain budgetary allocations to key social sectors including education. As a result, investment in education has been seriously affected, and this will undoubtedly impact on the quantity and quality of education in future (Shariff, Ghosh and Mondal, 2002, p. 6).

In this section, we discussed the trends in expenditures of the Central government alone. However, while total expenditure by the Centre has significant implications on macroeconomic variables, the share of the Centre’s expenditure on social services is small. About 85 percent of the spending in social services in India is undertaken by the State governments. In a sector like education, the share of States’ expenditure in total expenditure was 89 percent in 1999-00. In other words, it is the ability of the States, rather than the centre,

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[12] Such a policy stance was articulated by Manmohan Singh, the Union Finance Minister in the early 1990s, in the following words: Some people have criticised the stabilisation programme as being anti-poor. I admit that in an economy, which has been living beyond its means, stabilisation does hurt…It is true that fiscal compulsions have forced us to restrain the growth of all expenditure, including social expenditure. But…we had very little option but to do what I did. Those who criticise the cuts in social spending should tell us what other expenditure could be cut to make room for increased spending on social sectors (Singh, 1992, pp. 3-4, cited in Mahendra Dev and Mooij, 2002).

to spend on social services that matters more for human development. Further, States are responsible for most of the infrastructure services (except telecommunications, civil aviation, railways and major ports), and law and order. It is to the analysis of the expenditure patterns of States that we turn to in the next section.

III Analysis of Expenditures – State Governments

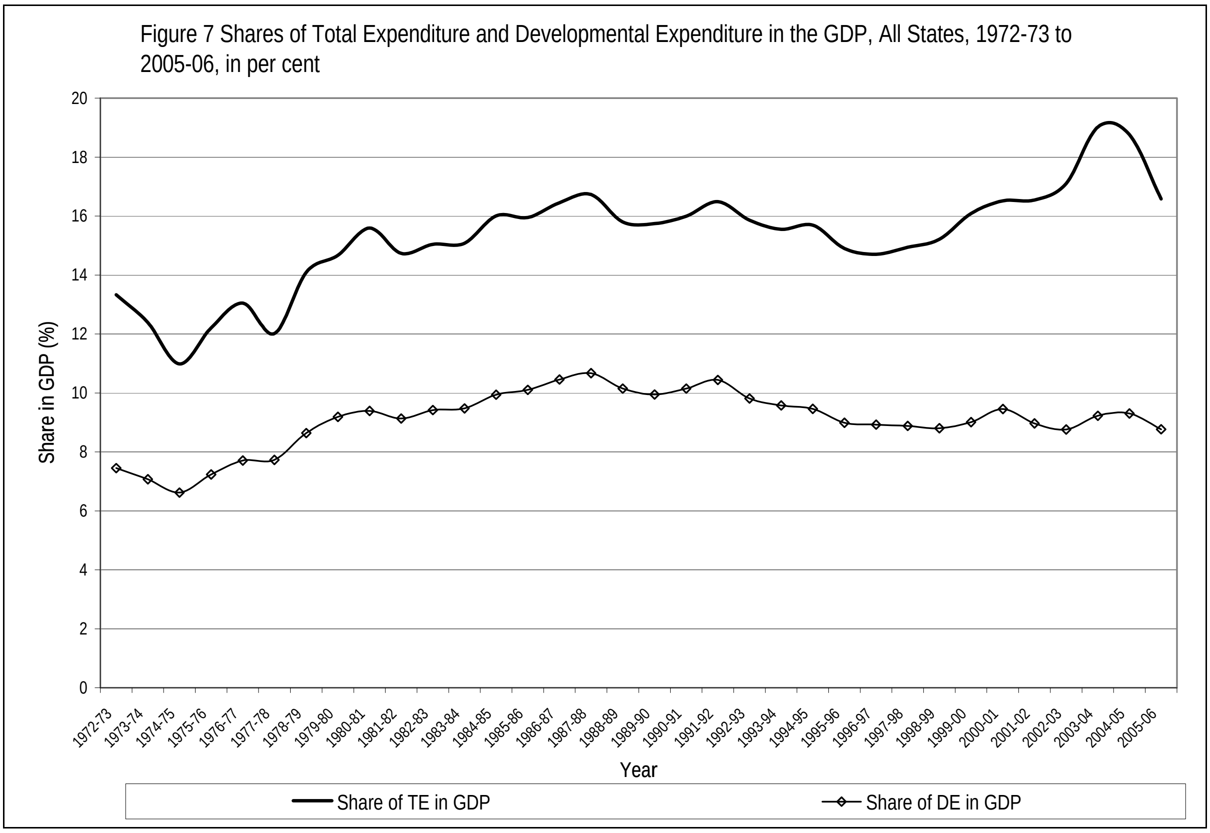
In this section, as in the previous section, I shall discuss trends in the levels and composition of expenditure by States in terms of the different expenditure ratios.

Public Expenditure Ratio and Developmental Expenditure

Between the mid-seventies and 1991-92, the PER of States increased significantly from about 11 percent to 16.5 percent (Figure 7). However, between 1991-92 and 1997-98, there was a decline in the share of expenditure of States in the GDP. There was a recovery in the PER between 1997-98 and 2003-04, followed by a fall in the last two years. The fall in the last two years was sharp enough to bring down the PER in 2005-06 to 16.6 percent, which was actually lower than the PER in 1987-88 and almost equal to the PER in 1991-92.

When we consider the share of developmental expenditure in the GDP for all States, a different conclusion emerges for the 1990s and 2000s. After rising significantly from 6.6 percent in 1974-75 to 10.4 percent in 1991-92, the share of developmental expenditure in the GDP declined to 9.5 percent in 2000-01 and 8.8 percent in 2005-06 (Figure 7). There was no recovery in the share of developmental expenditure to the GDP in the 2000s as noted for the PER. The fall in share here was almost continuous between 1991-92 and 2005-06. In other words, the rise in PER for States noted for certain years of the 1990s actually represented a rise in non-developmental expenditures.

In Table 4, I have presented period-wise rates of growth of selected items of expenditure by the States. The total expenditure of the States, which grew at 4 percent per annum in the 1980s, grew at a slower rate of 3.2 percent per annum in the 1990s. However, in the 2000s, the growth of total expenditure picked up significantly to 6.7 percent. Clearly, these trends in growth rates conform to our discussion on the changing shares of total expenditure by States in the GDP. In the case of developmental expenditure also, the growth rate in the 2000s was higher than that in the 1990s (see Table 4). However, this higher growth rate in the 2000s was not sufficient to raise the share of developmental expenditure in the GDP to levels higher than in the early-1990s (see Figure 7). Within developmental expenditure, the increase in the growth rate in the 2000s was driven primarily by a rise in expenditures in Economic Services, and specifically, Rural Development where the growth rate was negative in the 1990s but 9 percent per annum in the 2000s.



However, the higher growth rate of States' developmental expenditure in the 2000s does not appear to reflect in a rise in its *share* in total expenditure. As Table 5 shows, the share of developmental expenditure in total expenditure increased in the 1980s, but declined in the 1990s and 2000s continuously. Between 1990-91 and 2004-05, the share of developmental expenditure fell sharply from 63.5 percent to 49.6 percent. Within developmental expenditure, the share of both Social Services and Economic Services declined in the 1990s and 2000s. Between 1990-91 and 2004-05, the share of expenditure on Social Services fell from 32.1 percent to 26.4 percent. Between 1990-91 and 2004-05, the share of expenditure on Economic Services fell from 31.4 percent to 23.4 percent. Even though Rural Development (within Economic Services) had registered a very high growth rate of 9 percent per annum in the 2000s, its share in total expenditure rose only moderately from 3.2 percent in 2000-01 to 3.5 percent in 2004-05.

Table 4: ***Compound annual growth rates of per capita expenditure of State governments under selected heads, revenue and capital, 1972-73 to 2005-06*, in percent per annum**

Item	Compound annual rates of growth (percent)			
	1972-73 to 1979-80	1980-81 to 1989-90	1990-91 to 1999-00	2000-01 to 2005-06
1. Developmental Expenditure	**5.4**	**4.5**	**2.0**	**4.5**
1.1 Social Services	**3.0**	**5.4**	**3.7**	**3.4**
1.1.a. Education, Arts and Culture	4.9	6.1	3.8	1.2
1.1.b. Medical, Public Health and Family Welfare	7.4	-1.2	2.6	2.7
1.1.c. Water Supply and Sanitation	-	6.4	4.7	4.9
1.1.d. Housing	12.4	6.0	3.4	4.3
1.1.e. Urban Development	-	9.7	7.6	16.4
1.1.f. Welfare of SC, ST and OBC	-	3.9	3.0	8.5
1.1.g. Labour and employment	17.5	-1.2	1.2	3.6
1.1.h. Social Security and Welfare	9.9	-9.0	2.4	9.7
1.1.i. Nutrition	-	10.2	9.1	4.5
1.2. Economic Services	**11.4**	**3.7**	**0.1**	**6.3**
1.2.a. Agriculture and Allied Services	8.8	-4.8	-0.4	2.9
1.2.b. Rural Development	-	-2.1	-1.8	9.0
2. Non-Developmental Expenditure	**1.3**	**7.0**	**6.9**	**6.0**
3. Total Expenditure	**3.7**	**4.0**	**3.2**	**6.7**

Source: Computed from *RBI Bulletin*, various issues.

On the other hand, what grew in share significantly in the 1990s and 2000s was the States' expenditure on non-developmental items. Between 1990-91 and 2004-05, the share of non-developmental expenditure increased from 24.3 percent to 32.8 percent (see Table 5). As Table 5 shows, non-developmental expenditure continued to grow at a high rate of 6.9 percent per annum in the 1990s and 6 percent in the 2000s (see below for a detailed discussion).

Social Sector Expenditure and Social Allocation Ratio

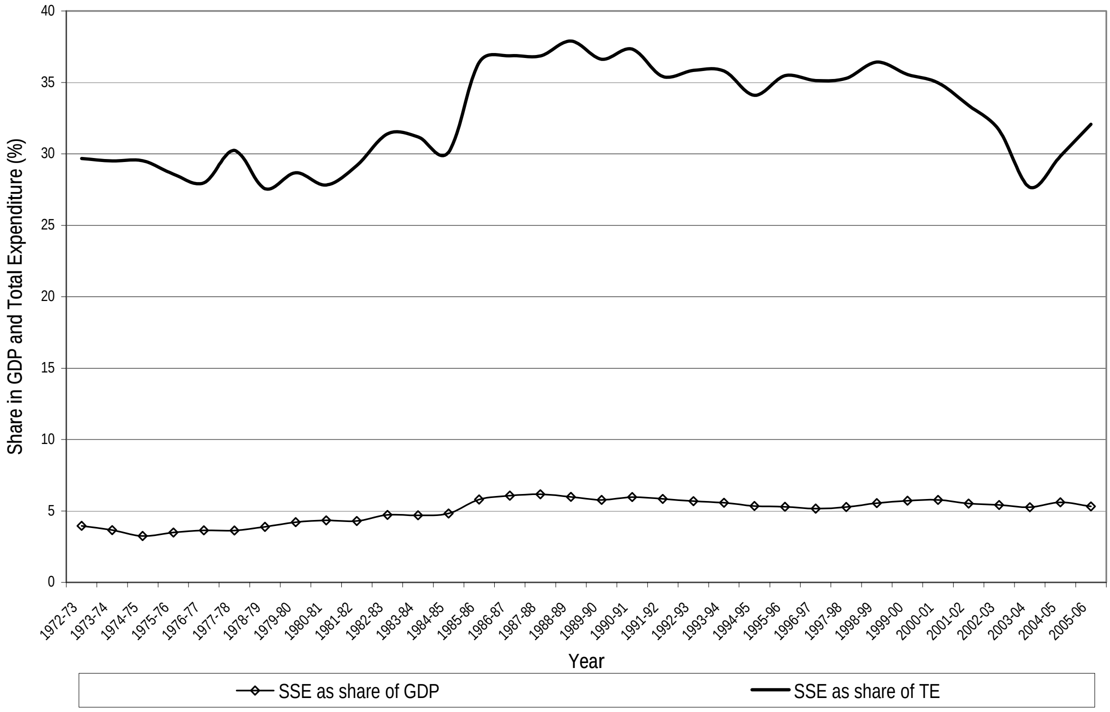
As a share of the total expenditure, the social sector expenditure (SSE) of the States has almost continuously fallen from 1990-91 onwards (Figure 8). The Social Allocation Ratio (SAR) for all States had risen considerably in the 1980s, from 27.8 percent in 1980-81 to 37.3 percent in 1990-91. Between 1990-91 and 2003-04, the SAR for all States fell from 37.3 percent to 27.7 percent – a level lower than that in 1980-81. In the last two years, there was a small recovery in the SAR from a long-term falling trend.

Table 5: ***Share of selected heads of expenditures in total expenditure of State governments, revenue and capital, 74-75 to 04-05,*** **in percent**

Item	1974-75	1980-81	1985-86	1990-91	1995-96	2000-01	2004-05
1. Developmental Expenditure	**60.2**	**60.2**	**63.4**	**63.5**	**60.3**	**57.2**	**49.6**
(a) Social Services	**29.5**	**27.8**	**31.4**	**32.1**	**31.7**	**31.8**	**26.4**
(i) Education, Arts and Culture	16.3	13.9	15.4	17.4	16.5	17.4	13.1
(ii) Medical and Public Health	7.3	7.1	6.2	5.3	4.0	4.0	3.1
(iii) Family Welfare	-	-	-	-	1.0	0.7	0.5
(iv) Water Supply and Sanitation	-	-	2.0	2.2	2.3	2.4	2.2
(v) Housing	0.7	0.6	0.6	0.6	0.6	0.6	0.5
(vi) Urban Development	-	-	0.6	0.7	0.8	1.0	1.3
(vii) Welfare of SC, ST and OBC	-	-	2.0	2.1	2.0	1.9	2.0
(viii) Labour and employment	0.5	0.9	0.6	0.5	0.4	0.4	0.3
(ix) Social Security and Welfare	2.5	3.2	1.7	1.5	1.4	1.4	1.6
(x) Nutrition	-	-	0.4	0.6	1.2	0.7	0.6
(b) Economic Services	**30.7**	**32.4**	**31.9**	**31.4**	**28.7**	**25.3**	**23.4**
(i) Agriculture and Allied Services	11.7	12.4	8.2	7.6	6.0	4.8	3.9
(ii) Rural Development	-	-	5.0	5.3	3.8	3.2	3.5
(iii) Special Area Programmes	-	-	0.5	0.6	0.5	0.7	0.4
(iv) Irrigation and Flood Control	-	-	10.0	7.8	7.6	5.6	5.5
(v) Energy	-	-	1.0	2.2	3.9	5.0	5.7
(vi) Industry and Minerals	1.8	1.6	2.0	1.9	1.4	0.9	0.8
(vii) Water and Power Development	9.6	10.7	-	-	-	-	-
(viii) Transport and Communication	5.0	2.5	4.1	1.5	4.2	3.5	3.3
(ix) General Economic Services	2.7	2.4	1.1	2.7	0.4	0.4	0.6
2. Non-Developmental Expenditure	**21.9**	**18.3**	**20.9**	**24.3**	**30.9**	**34.3**	**32.8**
3. Others	**17.9**	**21.5**	**15.7**	**12.2**	**8.8**	**8.5**	**17.6**
4. Total Expenditure	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Computed from *RBI Bulletin*, various issues; *State Finances: A Study of Budgets*, RBI, various issues.

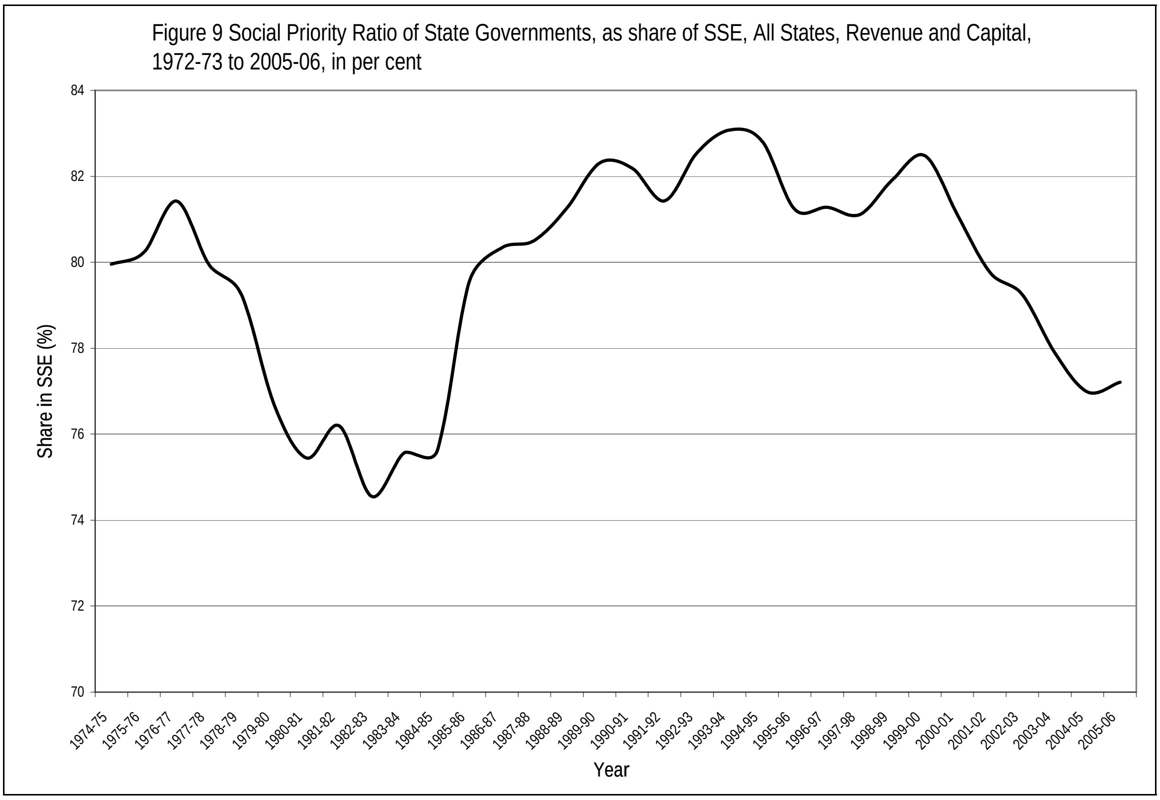
Figure 8 Social Sector Expenditure as share of GDP and Total Expenditure, All States, Revenue and Capital, India, 1972-73 to 2005-06, in per cent



As a share of the GDP, the SSE declined in the 1990s and 2000s after a long period of rise from the late-1970s (Figure 8). In 1990-91, the share of SSE in the GDP was about 6 percent; the corresponding figures in 1999-00 and 2005-06 were 5.7 percent and 5.3 percent.

Social Priority Ratio

The Social Priority Ratio (SPR) of States, as in the case of SAR, increased in the 1980s until the early-1990s (Figure 9). Between 1980-81 and 1993-94, the SPR increased from 75.4 percent to 83.1 percent. After 1993-94, however, there was a sharp fall in the SPR right up to 2005-06. The sharpest fall in the SPR took place in the 2000s. While between 1993-94 and 2000-01, the SPR declined from 83.1 percent to 81.1 percent, the SPR for 2005-06 stood at a far lower level of 77.2 percent.

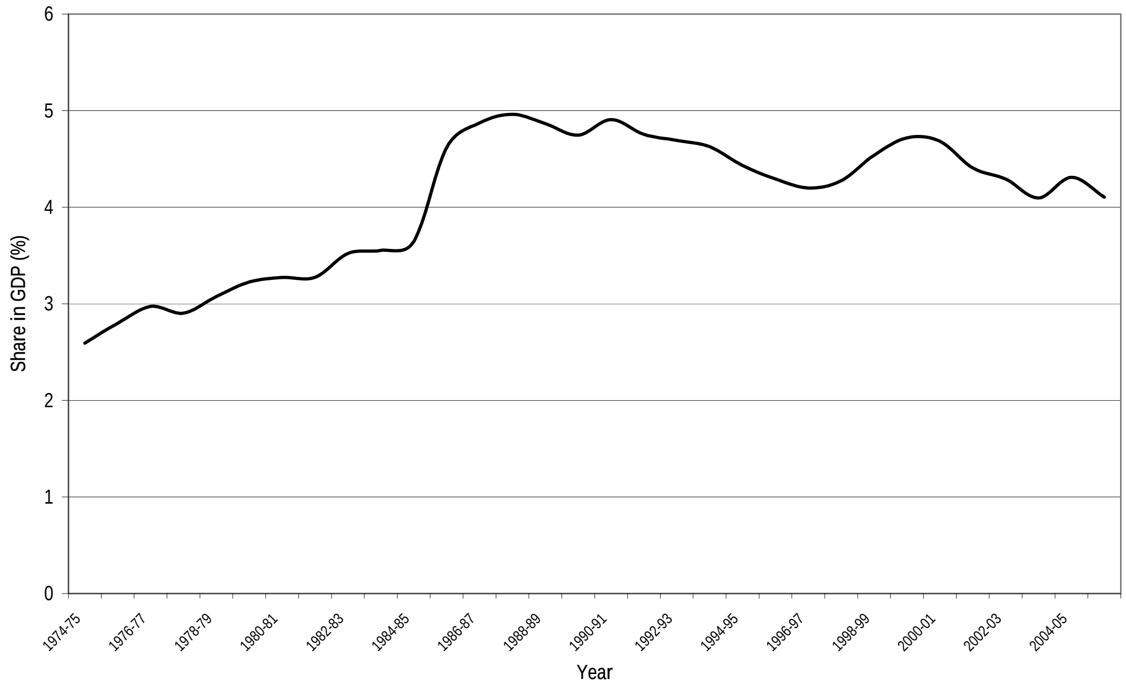


Our results show that while there was a general shift of SSE away from the human priority areas in the 1990s, the phenomenon worsened in the 2000s. A look at the changing shares of expenditures under different sub-heads in Table 5 shows that in all but one of the human priority areas, the fall in share of expenditures in the 2000s was sharper than the fall in share of expenditures in the 1990s. For instance, in education, after remaining almost stagnant in the 1990s, fell from 17.4 percent in 2000-01 to 13.1 percent in 2004-05. Similarly, the share of expenditure in Medical, Public Health and Family Welfare *together* declined from 4.6 percent in 2000-01 to 3.7 percent in 2004-05. Even in Rural Development, which registered a high growth rate in per capita terms in the 2000s, the share of expenditure in 2004-05 was lower than that in 1995-96.

Human Expenditure Ratio

The changes in the Human Expenditure Ratio (HER) of all States can be easily explained in terms of two phases: a period of rising levels from the mid-seventies till about 1990-91 and a period of decline from 1990-91 to 2005-06 (Figure 10). Between 1990-91 and 2005-06, the HER of all States declined from 4.9 percent to 4.1 percent. In other words, in the 1990s, there was a fall in the expenditure in human priority areas as a share of the GDP, a trend opposite to that in the 1980s. It is notable that the HER did not exhibit a rise in the 2000s even while one of its components – Rural Development – registered a sharp rise in its growth rate.

Figure 10 Human Expenditure Ratio of State Governments, as share in GDP, All States, Revenue and Capital, 1972-73 to 2005-06, in per cent



In sum, our discussion on broad expenditure patterns of States shows that the total expenditure of States, as a share of GDP, rose in the 1980s, fell in the first half of the 1990s and then continued to rise into the 2000s. However, this increased total expenditure was not flowing into developmental expenditure, but non-developmental expenditure, which included different forms of debt-servicing. *The share of developmental expenditure of States in GDP declined in the 1990s as well as the 2000s.* Reflecting this shift away from developmental expenditure, the share of SSE in total expenditure, the share of social priority expenditure in SSE and the share of social priority expenditure in GDP declined in the 1990s and the 2000s. In other words, *the trends in social and economic expenditures of the States in the 1990s and 2000s represent a major reversal of achievements on this front in the 1980s.*[13]

Sector-wise expenditures as a share of GDP

In Figure Panel 11, I have presented trends in the expenditures under selected items by the States as a share of the GDP. It is notable that there emerges a more or less uniform trend for most of the items of expenditure examined here. It may be convenient to group the trends into three:

(a) In sectors like Education, Housing and Rural Development, there was a rise in the share of expenditure by States in the GDP in the 1980s. The above trend progressed at least till the second half of the 1980s. In the 1990s and 2000s, in all the above sectors, the share of expenditure in GDP declined sharply.

[13] According a recent study on social sector expenditure by States, "…the slow real expenditure growth, in some cases negative, in particular in the poorer states, and the deterioration in the quality of expenditure, both of which were observed in the late nineties, contrasts with the need…for a large expansion in spending and quality of spending in these areas, especially in the low income states" (Howes, Murgai and Wes, 2004, p. 13).

(b) In sectors like Health, Water Supply and Sanitation, Agriculture and Allied Sectors, Welfare of SC, ST and OBC, Labour and Employment and Social Security and Welfare, the share of expenditure in GDP began to decline in the 1980s itself. This decline continued into the 1990s and 2000s, resulting in a long-term fall in the share of expenditure in GDP.

(c) In Urban Development, there was a slow rise in the share of expenditure in GDP in the 1980s, but in the 1990s and 2000s, the share increased significantly. In Nutrition, the share of expenditure in GDP was stagnant in the 1980s, but it rose slightly in the 1990s and 2000s over a fluctuating trend.

The Crisis in State Finances and Expenditure Compression

As we have seen, the total expenditure and developmental expenditure of the States declined in the 1990s. In the 2000s, even while total expenditure grew moderately as a share of GDP, the share of developmental expenditure continued to fall. Such a trend owes its origin to the specificities of the crisis in State finances in India from the late-1980s and the response of the central government to this crisis.

The nature of the crisis in State finances may be briefly stated as follows. Until the mid-1980s, States as a whole in India were recording revenue surpluses in their budgets. However, from the mid-1980s onwards, the surplus turned into a deficit. This period also marked the end of the era of low and administered interest rates. The interest rates sharply increased thereafter, but its impact was masked by the presence of pre-existing cheap debt that the States had availed (Chaudhary, 2000). From the latter half of the 1990s, the high cost debts incurred since the mid-1980s took their toll on the interest burden of States and started a process of debt escalation.

The role of the Central government was critical in the process of deterioration of State finances (see Isaac and Ramakumar, 2006). As part of interest rate deregulation, the rates of interest on borrowings of States were sharply increased after the mid-1980s, and especially so after 1990-91 (see Table 6). The coupon rates of State government securities were raised sharply by the RBI from 1990-91 onwards. The weighted average of coupon rates, which was 11.5 percent in 1990-91, reached its historic peak of 14 percent in 1995-96. In the same period, the interest rates on small saving borrowings by States also increased from 13 percent in 1990-91 to 14.5 percent in 1992-93, and remained stable until 1997-98. These rates of interests that the States had to pay were clearly usurious, much higher than the growth rate of the GDP and thus, a sure recipe for a financial disaster. Even though the interest rates started falling thereafter, the financial burden that these periods of high interest rates placed on State finances was significant. As a share of total revenue receipts, these interest payments amounted to 13 percent in 1990-91, 16 percent in 1995-96 and 24 percent in 2001-02 (*ibid*.).

In the period in which the Centre was raising the rates of interest on States' borrowings, the rates of interest on the Centre's borrowings were not only lower in levels, but were also rising at a much slower rate. The result was that the differential between the rates of interest faced by the Centre and the States widened significantly in the 1990s, which has continued into the 2000s (see Chandrasekhar and Ghosh, 2005, EPWRF, 2004; Isaac and Ramakumar, 2006). The average rate of interest of States' borrowings was above 10 percent even in 2004, while that of the Centre had dipped below 7 percent.

Table 6: ***Key interest rates on State government borrowings from the Centre and the market, 1990-91 to 2005-06,*** **in percent per annum**

Year	Coupon rates on State government securities (weighted average)	Interest rates on Small Savings borrowings by States	Interest rates on Plan and non-Plan loans from the Centre
1990-91	11.5	13.0	10.3
1991-92	11.8	13.5	10.8
1992-93	13.0	14.5	11.8
1993-94	13.5	14.5	12.0
1994-95	12.5	14.5	12.0
1995-96	14.0	14.5	13.0
1996-97	13.8	14.5	13.0
1997-98	12.8	14.5	13.0
1998-99	12.4	14.0	12.5
1999-00	11.9	13.5	-
2000-01	11.0	12.5	-
2001-02	9.2	11.0	-
2002-03	7.5	10.5	-
2003-04	6.1	9.5	-
2004-05	6.4	9.5	-
2005-06	7.6	9.5	-

Source: Isaac and Ramakumar (2006).

In 1997-98, there was another shock to State finances when the recommendations of the Fifth Pay Commission were implemented. This measure sharply raised the levels of revenue deficit of States from 1997-98 onwards. In just one year, the revenue deficit of States more than doubled – from 1.1 percent in 1997-98 to 2.5 percent in 1998-99. While I do not wish to neglect other factors, the rise in interest burden and higher salary payments constitute the two most prominent factors responsible for the deterioration of State finances. The outcome of these two factors was a sharp rise in the debt burden of States. As a share of GDP, the total debt outstanding of States increased from 22.7 percent during 1995-00 to 31.7 percent during 2000-05 (see Table 7). Interest payments of States more than doubled as a share of the GDP between 1986-90 and 2000-05.

These changes are clearly visible when we analyse the long-term trends in the levels of revenue deficit and fiscal deficit of all States (see Table 7). Through the 1970s, States as a whole were enjoying a revenue surplus. It was only by the late-1980s that the revenue account of States fell into deficit. The revenue deficit increased gradually between 1986-87 and 1997-98, and thereafter increased sharply until 1999-2000. Driven by the rise in the revenue deficit, the fiscal deficit of States rose sharply after 1997-98.

Table 7: ***Selected fiscal indicators of States as a whole, 1976 to 2005, as share in GDP*****, in percent**

Item	Shares in GDP (percent)					
	1976-80	1981-85	1986-90	1991-95	1996-00	2000-05
Gross transfers from the centre	6.0	6.7	7.6	6.9	5.5	5.2
Net transfers from the centre	5.2	5.9	6.7	6.3	5.0	3.9
Total liabilities	-	19.2	22.3	22.1	22.7	31.7
Gross fiscal deficit	2.0	2.8	3.0	2.8	3.4	4.1
Revenue deficit	-1.1	-0.4	0.2	0.7	1.6	2.2
Expenditure on**:**						
Interest payments	0.8	0.9	1.3	1.7	2.0	2.8
Administrative services	1.0	1.1	1.2	1.2	1.1	1.1
Pensions and other services	0.2	0.3	0.5	0.8	1.1	1.4

Source: "Handbook of Statistics on the Indian Economy", RBI, various issues.

The trends in different heads of expenditures of States discussed in this paper are better understood in the context of the above fiscal crisis. *The debt burden of States – a result of long-term distortions in centre-State economic relations in India – have prevented them from raising the levels of developmental expenditures in general as well as expenditures in specific human priority areas.* Given the fact that about 85 percent of the expenditure in social services is undertaken by the States, the fall in social sector and human priority expenditures at the State-level has ominous implications.

The response of the central government to the crisis in State finances has been unsatisfactory. From the late-1990s onwards, the centre began to persuade the States to pass State-level fiscal responsibility legislations. In addition, for the first time, the Eleventh Finance Commission (EFC) started the process of linking resource transfers and other benefits from the Centre to fiscal consolidation by States. The passage of the FRBM Acts at the State-level became an indicator of the progress achieved by States in fiscal consolidation. States were asked to model their legislations on the legislation prepared by the Centre. As on August 2006, 23 States had passed State-level FRBM Acts (Ministry of Finance, 2006).

Further, there have been a number of criticisms over the Finance Commissions of the Centre exceeding their constitutional brief and proposing conditionalities on central transfers to States. In fact, under Article 275 of the Constitution, the Finance Commissions have no powers to impose conditionalities on resource transfers to States. However, the terms of reference of the Eleventh Finance Commission (EFC) included the mandate to "draw a monitorable fiscal reforms programme aimed at reduction of revenue deficit of the States and recommend the manner in which grants to States…may be linked to progress in implementing this programme". The Twelfth Finance Commission (TFC) recommended a fiscal restructuring plan for States, according to which (a) the revenue deficit had to be eliminated by 2008-09; and (b) the fiscal deficit had to be brought down to 3 percent in 2008-09. The TFC, in order to address the rising debt burden of States, also recommended a general scheme of debt relief and a loan write-off scheme. The benefits of both these schemes were to be made available to only those States that had passed fiscal responsibility legislations. These strictures by the FCs, apart from being an intrusion into the federal autonomy of States, also shut out the possibilities of any immediate increase in the developmental and social expenditures by the States.

The argument that a rise in the developmental and social expenditures may be impossible in the presence of FRBM Acts was raised recently by an official agency itself: the Planning Commission. In the draft approach paper to the 11th Five Year Plan, the Commission outlined a strategy that included a number of new initiatives, such as the expansion of school education and programmes for provision of health care, drinking water and rural infrastructure. However, it noted that none of the new programmes could be implemented if the FRBM/TFC targets of elimination of revenue deficit are stuck to. It may be apt to quote from the draft of the approach paper:

> …it may not be easy for the Centre to cut the revenue deficit from 2.1 percent in 2006-07 to 0 percent in 2008-09 while also achieving large increases in Plan expenditure with a high revenue component. Indeed, the very thrust of the approach to the 11th Plan presented in this paper, which involves combining innovative financing of infrastructure with a massive decentralised thrust on education, health and agriculture, may be defeated if the FRBM discipline is insisted upon… (GoI, 2006).

V Concluding Comments

This paper was an enquiry into changes in the levels and composition of expenditure by the central and State governments in India on the social and economic sectors. Using the "functional classification" of expenditures in the budget documents, I tried to discuss trends in expenditure between 1950-51 and 2005-06, with special emphasis on understanding trends in the period of economic reforms in India in the 1990s and 2000s.

An important concern raised by many development economists during the implementation of economic reforms in India was that the fiscal adjustment strategy may adversely affect the social sector expenditures. It was argued that the single-minded emphasis on reducing budget deficits may result in the relative reduction of expenditures in the 'soft" sectors (see Chandrasekhar and Ghosh, 2002).

The results of this paper show that, overall, these fears were largely real. A long run outcome of the fiscal policy in India was the inability of the state to raise tax collections towards meeting expenditure requirements (GoI, 2004). In the 1980s, the expenditure by the government in India had increased significantly, as a share of the GDP, in a large number of anti-poverty programmes and employment-creating activities. As these higher levels of expenditures were financed out of borrowings, the debt-GDP ratio of the government rose sharply. A fiscal crisis followed, which led to a fiscal adjustment policy from 1992 onwards. The fiscal crisis was most severe for the central government. The fiscal crisis of the Centre adversely affected the transfer of statutory funds to the States; the transfers from the Centre to the States declined in the 1990s. In addition, the deregulation of interest rates after 1991 led to a sharp rise in the interest rates that States had to pay, which led to a sharp rise in the debt burden of States. In sum, the finances of the States also entered into a period of crisis by the early-1990s.

In India, while the expenditure stance of the Centre has greater influence on the generation of aggregate demand, the expenditure stance of the States is more critical in the financing of social sector schemes. About 85 percent of all the expenditure in the social services is met by the State governments.

The response of the state in India to the fiscal crisis has been to go in for strict fiscal control measures, including a legally set ceiling on budget deficits through fiscal responsibility legislations. Our results show that the public expenditure of the central government declined sharply in the 1990s and 2000s, as compared to the 1980s. While there was some increase in the share of social sector expenditures and human priority expenditures as a share of the total expenditure, three important qualifications may be in order. First, as we tried to show, real per capita expenditure on human priority areas actually slowed down in the 1990s and 2000s relative to the 1980s. Secondly, in the framework of a slowdown in public expenditure as a whole, rising shares may mean little absolute increase in spending and rising growth rates may be unsustainable. Thirdly, on the ground, these moderate increases in expenditure by the centre have mattered little because most of the expenditure is through the State governments.

For the State governments, the conclusions that emerge are at variance with those of the Centre. The total expenditures by the States as a share of the GDP rose in the 1990s and early-2000s, but this rise was primarily to finance non-developmental expenditures like interest payments. Within total expenditure, the share that went into developmental expenditure declined in the 1990s and 2000s. Developmental expenditure as a share of the GDP also fell in the same period. In the case of social sector expenditures and human priority expenditures by States (the sphere where majority of the social sector expenditure took place), there were unambiguous falls relative to GDP and total expenditure. Within specific sub-sectors like education and health too, this relative decline in expenditure was visible.

Expenditure by the government on social and economic services is a crucial necessity for fulfilling the basic needs of people in developing countries. In India, this democratic function of the government would appear to face a serious threat from the nature of fiscal crisis that has developed. A transcending of this fiscal crisis is critical to liberating the government from constraints in spending, and reducing the social costs of spending cuts. However, to transcend the present fiscal crisis, a progressive transformation of the nature of fiscal policy would be required.

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