CHAPTER - X

SUMMARY, CONCLUSIONS AND POLICY RECOMMENDATIONS

The unprecedented rise in the volume of economic activity of government has been viewed by economists and persons associated with public policies with concern. The recent experience of the Indian Economy is no exception. In India in 1950-51 the ratio of total government expenditure to GNP was 9.8 per cent which increased to 31.8 percent in 1989-90. Not only there is increase in the growth of government size but also there is an all-pervasive effect of increase in this size on various sectors of the economy. One cause of concern has been its crowding out of private investment in the economy and the consequent distortions in resource allocation and increase in market imperfections in the economy. Increase in the size of government also leads to growth of bureaucracy which along with other interest groups bring about further market distortions. These tendencies are also reflected in changing composition of government expenditures. This study therefore has attempted to analyse growth of government expenditure in Gujarat as an indicator of government size and the changes in the structure of government expenditure in relation to growth of the economy.

The study begins with a brief discussion on the role of the state in a theoretical perspective as well as under conditions of market failures. It also discusses the

1. V. Sundarajan and Subhash Thakur, "Public Investment, crowding Out and Growth; A Dynamic Model Applied to India and Korea," International Monetary Fund Staff Papers, 80, pp. 814-55
significance of government failure. An overview of the general budgetary position and financial conditions of the Gujarat state has also been discussed. The various studies on growth of government have been reviewed to provide a background for the present study.

In this study, the analysis has been done using the economic and functional classification of the expenditure data, as given in the various publications of Bureau of Economics and Statistics, Government of Gujarat. This is because the expenditure data as given in the government budget is classified departmentwise for the purpose of securing legislature control and administrative accountability. This reveals only the financial transactions and not the economic and social significance of the transactions. Therefore the reclassification of the expenditure data into economic and functional categories have been used to properly understand the nature of the impact of the budgetary operations on the state economy.

The analysis of the economic and functional expenditure of the state has been done in the following four different ways to derive some meaningful conclusions from it:

(1) A detailed analysis of the expenditure data has been carried out in order to find out the trends, composition and changes in the structure of expenditure. The overall growth has been calculated using semi-logarithmic regression model. However, due to sudden jumps or breaks
in the data at certain intervals, we have divided the total period into one or two subperiods and then the growth rates for these subperiods have been calculated using kinked exponential model by introducing dummy variables. The sensitivity of growth rates estimates to instability is thus reduced by the kinked exponential method. This provides more accurate estimates of underlying trends.

(2) The income elasticities of government expenditures have been calculated as an attempt to measure the relationship between the growth of state government expenditure and state domestic product.

(3) We have also made an attempt to study the determinants of government expenditure at the state level. Fabricant Soloman\(^1\) for the first time made such a study for the United States in 1952. Multiple regression technique of analysis for this purpose has been used in the present study where four variables have been used as independent variables. These variables are urbanization, rate of inflation, net state domestic product and the time. The multiple regression analysis has been carried out using three different models for both economic as well as functional categories of expenditure. The first model uses three regressors influencing the government expenditure. These three regressors are: urbanization, rate of inflation, and the net state

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1. Fabricant Soloman, op.cit.
domestic product. In the second model time (T) has been added as the fourth regressor influencing the expenditure. Finally, in the third model we have added dummy variables for each of the regressors over and above the regressors themselves. The dummy variables have been introduced to take into account the structural changes in the expenditure.

(4) The analysis of the expenditure data has also been done in terms of studying the causality between the government expenditure and economic growth measured in terms of state domestic product. This analysis has been done because of the fact that the attempts to explain growth trends in public spending follow certain pre-conceived notions regarding the type of causal relationship between government expenditure growth and economic development. As a result, these attempts suffer from certain inbuilt specification biases. A more scientific method would be to first establish the causal directions before conducting detailed empirical exercises on the determinants of expenditures. The need to empirically examine the causality directions arises particularly as popular theoretical explanations have led to contradictory views regarding the direction of causation.
Major conclusions of this study are as follows:

(1) The income elasticity analysis shows that the coefficient is greater than one for all but one item of economic categories (expenditure on government services). Similar analysis for functional category also shows same trend for all but one of its categories (i.e. health). In both economic as well as functional category, the highest elasticity is for the interest payments (1.70 under economic category and 1.60 under functional category).

(2) The analysis of expenditure trends, in terms of their determinants shows that urbanization is an important factor explaining rise in government expenditure at aggregate level as well as for individual categories such as agriculture, industry and mining, economic and social services, miscellaneous expenditure and interest payments. There is a strong evidence in favour of structural shift in the effect of urbanization. Inflation rate has positive but weak effect while Net State Domestic Product (NSDP) does not have consistent relationship with government expenditure. The three determinants together, along with time trend explain considerably the variations in government expenditure at aggregative and individual category levels. However, interrelationships among the determinants adversely affect the reliability of individual regression coefficients.
(3) The causality test conducted on government expenditure and state Domestic Product to judge the direction of causality does not conclusively establish the direction of causality any one way. Therefore at aggregative level it is difficult to establish whether aggregative government expenditure is dependent on SDP or vice versa. At disaggregative level, however, the causality test shows some definite results. In case of general services the causal direction is from government expenditure to income. This is understandable because general services comprise of services to maintain law and order which is conducive for economic growth. In case of educational and health services, which are two important components of social services, the causality is observed to run from income to government expenditure which reflects the fact that provision of education and health services by state government are largely demand determined which is proxied by income or level of economic development.

(4) Causality test conducted on expenditures pertaining to industry and mining and transport and communication show causal direction flowing from government expenditure to income. This is probably due to crowding-in effects and lends support to the theories justifying government intervention in the infrastructure sectors.
(5) The study shows that while total expenditure in nominal terms increased substantially i.e. by 63 times and in real terms it increased 6 times, expenditure per head of population increased 3 times and expenditure in relation to community output increased 2 times between 1963-64 to 1992-93.

(6) In relation to growth of aggregate economic activity, the rise in government expenditure has been much faster. For example, during the period 1963-64 to 1992-93 the share of total government expenditure in SDP in real terms increased from 13 per cent to 27 per cent, thus doubling in 30 years. The government therefore have been taking away larger and large share from the community's output over a period of time.

(7) The ratio of government expenditure to SDP increased on an average from 14 percent in 60's to 17 percent in 70's and then to 24 percent in 80's. Thus in real terms, government expenditure has increased much faster than the rise in both, population and state output.

(8) The expenditure when analysed in terms of functional categories shows almost a similar pattern as that observed for expenditure by economic category.
(9) The analysis of the structure of government expenditure shows that transfer payments have increased by 105 times during the period of study.

(10) The consumption expenditure has increased 58 times in nominal terms, 5 times in real terms, per capita nominal terms 20 times and per-capita real terms 3 times.

(11) It has been observed that the increase in consumption expenditure is mainly due to increase in government expenditure on wages and salaries of its employees. As compared to expenditure on goods and services, expenditure on wages and salaries has increased faster.

(12) The overall share of consumption expenditure in total expenditure has fallen while that of current transfer payments has increased sharply. This is mainly due to a sharp increase in interest payments and subsidies. Thus the overall annual growth rate was 9.5 per cent and 9.8 per cent for the interest payments and subsidies respectively for the period 1963-64 to 1992-93.

(13) The expenditure on account of subsidies increased in real terms by 26 times and in nominal terms by 279 times. Thus one of the important
reasons for the tremendous increase in subsidies has been the erosion of money due to inflationary pressure becoming more acute in 80's. However, this does not undermine the fact that the subsidies by itself have increased substantially. Its share in total expenditure increased four times and that in SDP increased seven times in 30 years. In fact in the current expenditure, subsidies is one of the major growth components.

(14) Interest payments is another major component of increase in current expenditure. In nominal terms the total expenditure on account of interest payments increased 132 times, in per capita nominal terms it increased 66 times, in real terms it increased 13 times and in per capita real terms by 6 times in 30 years. Its share in total expenditure almost doubled and that in SDP increased four times from 0.8 percent in 1963-64 to 3.2 per cent in 1992-93. Thus the fact that 3 per cent of the income generated in the state goes towards payment of interest only shows that the state government has been continuously spending more than the resources on its hand and to fill the gap it has heavily relied on borrowings thus increasing the debt burden for future generations.

(15) The share of the expenditure on account of grants to local bodies has declined from 19 per cent in 1963-64 to 13 percent in 1992-93. This
has serious welfare implications as 40 per cent of this grant is meant for primary education purpose. With the recent 73-74 Constitutional amendments, aimed at more decentralization, the local bodies and panchayati raj institutions are expected to be strengthened financially. Therefore this trend of decline in the share of local bodies needs to be emphasised. It is expected that the State Finance Commission will make necessary recommendations to strengthen them financially.

(16) On the one hand, there is decline or almost stagnation in grants to local bodies which are mainly to be spent on primary education and on the other hand, the expenditure on higher education amounts to 61 per cent of the total current transfers, thus clearly indicating misplaced objectives of a welfare state.

(17) There has been decline in the share of capital expenditure vis-a-vis current expenditure by 10 percentage points during the period of study, both in total expenditure as well as in SDP.

(18) The share of expenditure on account of capital transfer to local bodies in both total expenditure as well as in SDP has decreased.
There was substantial increase in expenditure on account of other capital transfer the large part of which (93 per cent) goes as investment in government's own commercial undertakings. The majority of these undertakings are making losses and therefore it seems that major portion of these investments goes towards making good these losses only and therefore may not lead to an actual increase in capital formation in the State.

In functional categories, the highest growth was observed for expenditure on account of miscellaneous item (which includes repayment of public debt) and interest payment.

The expenditure on general services, which mainly consists of administrative expenditure, is another major component of increasing functional expenditure.

The overall expenditure on economic and social services has declined from 20 per cent between 1971-78 to 16 percent between 1979-93.

The expenditure on all but one sub categories (except 'health') of economic and social services viz education, agriculture, industry and
mining, and transport and communication has shown a declining trend between the two sub-periods.

**Policy Recommendations**

(1) Our study on causality indicates that though at aggregate level there is no relation between expenditure and net domestic product, at disaggregated level expenditure on general services has influence on net state domestic product. Therefore an important policy implication is that there is a need to increase expenditure on them and these services need to be strengthened for facilitating faster economic development.

(2) The estimates of income elasticity indicates that there is a need to increase expenditure on health and education. Here we would like to emphasize that government should allocate more funds for primary education rather than higher education.

(3) The causality test shows that the causal direction is from government expenditure to income. This is probably due to crowding in effect. Therefore this points to the fact that there is a need to increase expenditure on infrastructural facilities to achieve faster economic
development. However mobilisation of resources by the state government alone would not be adequate to aim at a higher rate of growth and development infrastructure facilities. Therefore as suggested by Gujarat State Finance Commission Report (April 1994) in order to strengthen the health of various corporations and improve infrastructural facilities, there is no other way but to privatise some of these corporations and facilitate participation of the private sector in the effort. As emphasised in the Report, the purpose of disinvestment is not merely privatisation per se but for the purpose of releasing scarce resources for more pressing purposes. The proceeds of disinvestment should not be utilised by the State Government to cover revenue deficits in its budget but must be utilised for investment in infrastructural facilities which could lead to a higher rate of growth of the economy.

(4) There is also an urgent need to reduce expenditure on establishments and put a freeze on government employment. It is possible to reduce the total number of employees without undertaking harsh measures like retrenchment by simply putting a freeze on fresh recruitment in the state government and aided institutions, at least for sometime if not for a longer period. Government should no longer be seen as the main provider of jobs but as a catalyst facilitating rapid economic development through investment in infrastructure. Even in the area of social infrastructure government's intervention should be effective and goal-oriented without most of the resources being consumed by
expenditure on establishment. As per the estimates made by Rao\(^1\) for all the states, about 3 per cent of the employees superannuate every year, and therefore a freeze on employment, about 10 to 15 percent of the expenditure in the course of next five years.

(5) As has been indicated in analysis, one of the important reasons for increase in the government expenditure has been increased in the expenditure on account of subsidies. Given our social and economic conditions, state subsidies and social security for the poor will be justified for a long time to come. Therefore, the real issue is to ensure that such schemes are sharply focussed and narrowly targeted so that only the deserving and intended groups benefit from them. Subsidies must be direct, justified on the basis of specific parameter and aimed at specified beneficiaries who need such subsidy. Subsidy must never be indirect, implied and indiscriminate.

There should be no implicit or hidden subsidy. Subsidy must be specifically provided for in the budget Full cost recovery from those who can pay must be enforced. The studies conducted at the National Institute of Public Finance and Policy (NIPFP) have shown that implicit

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and explicit subsidy involved in the provision of social and economic services in the 14 major States in 1987-88 amounted to Rs.27,463 crore or 8.3 per cent of GDP. The NIPFP study also shows that in respect of every sector the recovery rates declined significantly during the decade 1978-88.\(^2\) Thus cost recovery through proper user charges is an important area whereby more revenues can be raised. There is a need for proper pricing of services like higher education, irrigation and electricity, which will help to raise larger revenues and result in the more economic use of resources. Thus in social services, social welfare and social subsidies, the government should cater only to the poor, and the nonpoor should be made to look to the market.

6. The analysis of expenditure in terms of elasticity shows that the highest elasticity is for the item-interest payments. The share of expenditure on account of interest payment was 9.5 percent, a major component of increase in current expenditure. Its share in total expenditure almost doubled and that in SDP increased four times. Thus, the state faces an explosive cycle of revenue expenditure growth and are virtually in the theories of a debt trap. Given that the growth rate of revenues, particularly that of tax revenue is already reasonably high, it may not be possible to accelerate their growth further without seriously affecting

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the incentives. Therefore, there is an urgent need to concentrate on decelerating growth of expenditures and phasing out of the hidden subsidies through the levy of proper user charges.

7. One of the characteristics of the modern state is to initiate several programmes in various fields of activities. These programmes although started on temporary basis have a tendency to perpetuate themselves and same is the case with many temporary appointments in Government. It appears that all government programmes have three things in common - a beginning, a middle, and no end. If a serious scrutiny of all the Government programmes is made many of them may be totally useless and need to be axed. Therefore what we need is strict implementation of zero-based budgeting which requires that every department must justify every programme each year. One of the advantage of zero base budgeting is that since it is based on a comprehensive analysis of priorities goals and objectives it makes the entire budgeting exercise more realistic. The zero-based budgeting would lead to cancellation of many schemes which have become obsolete or have lost utility. It will therefore result into perceptible cut in budgets.
STATE GOVT. EXPENDITURE BY ECONOMIC CLASSIFICATION IN GUJARAT

EXPENDITURE (Thousands)

YEARS

63-64 69-70 75-76 79-80 85-86 89-90 92-93

---NOMINAL ---- REAL

CHART-1
PER CAPITA STATE GOVT. EXPENDITURE 
NOMINAL AND REAL TERMS

EXPENDITURE (Rs.)

YEAR

63-64 69-70 75-76 79-80 85-86 89-90 92-93

0 500 1000 1500 2000

Chart-2
SHARE OF EXPENDITURE IN SDP
(IN REAL TERMS)

EXPENDITURE

YEAR

SHARE IN SDP

Chart-3