ECONOMICS

PROJECT REPORT ON

IMPACT OF PUBLIC EXPENDITURE ON ECONOMIC GROWTH IN INDIAN CONTEXT

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INTRODUCTION

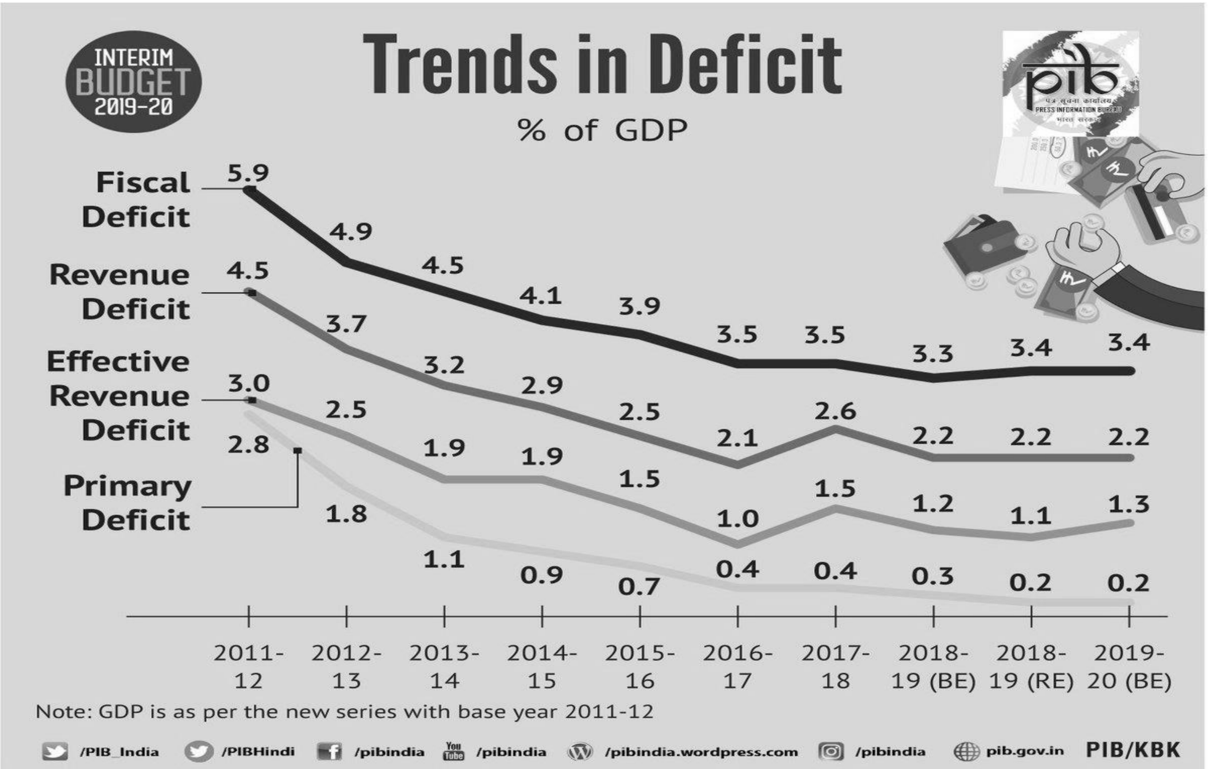
A predominant objective of public expenditure policy is clearly sustained and equitable economic growth. Many public programs are specifically aimed at promoting sustained and equitable economic growth. Public expenditures have played an important role in physical and human capital formation over a period of time. Appropriate public expenditures can also be effective in boosting economic growth, even in the short run. Therefore, the effect of public expenditures on economic growth may be a comprehensive indicator of public expenditure productivity. Ideally, the two components of such an indicator should be measurable: the contribution of public sector outputs to economic growth, and the efficiency with which these expenditures yield their outputs.

Government expenditure plays an important role in poverty reduction. According to Keynesian approach, public spending may increase the aggregate demand which further stimulates the economic growth and employment. Many studies show that government spending is positively related with economic growth. While increase in government spending may lead to fiscal deficit. But if government reduces their expenditure, it may adversely affect the economy. But the excess of government expenditure due to the current expenses or unproductive use over the taxes collection capacity of economy creates fiscal deficit.

The main objective is to establish the relationship between the amount of government expenditure and its overall impact on the GDP growth rate and economic growth of the country over the years, with focus on the Indian context. This also explains the aspects of laying down of a parliamentary budget, cause of public spending, increase in public expenditure to boost the economy and the success rate of governments in achieving the desired results. The research studies and government data taken into consideration are from pre-Covid era, therefore, may show some anomality with the present scenario given the serious impact it has caused to the world economy and its citizens.

1.1 FISCAL DEFICIT: A BRIEF OVERVIEW

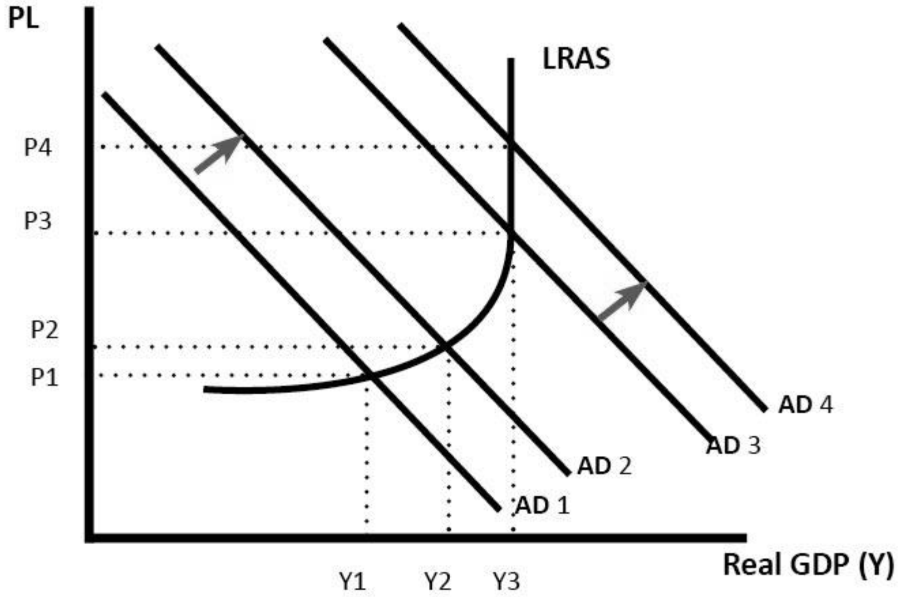
Furthermore, increases in debt to GDP ratio may have a negative impact on country's long run fiscal sustainability; it might affect the welfare of next generations. Many studies have found out that there exists a significant statistical relationship between fiscal deficit and many macroeconomic variables. Continuous increase in fiscal deficit creates distortionary effects in the economy. It may cause high inflation, low growth and crowding out of the private investment and consumption in the long run. The aforementioned variables further cause the poverty and decrease the welfare in the economy. The financing of fiscal deficit creates severe problem for poverty reduction. In most of the developing countries, fiscal deficit is financed through internal and external borrowing. The internal borrowing affects the interest rate and it crowds out the private investment in the long run. While external borrowing leads to current account deficit and appreciation of exchange rate which further decreases the net export of the country. Although high fiscal deficit is injurious for the economy and it increases poverty but if it increases due to development expenditure it can help reduce poverty in the long run through increase in productivity and employment.

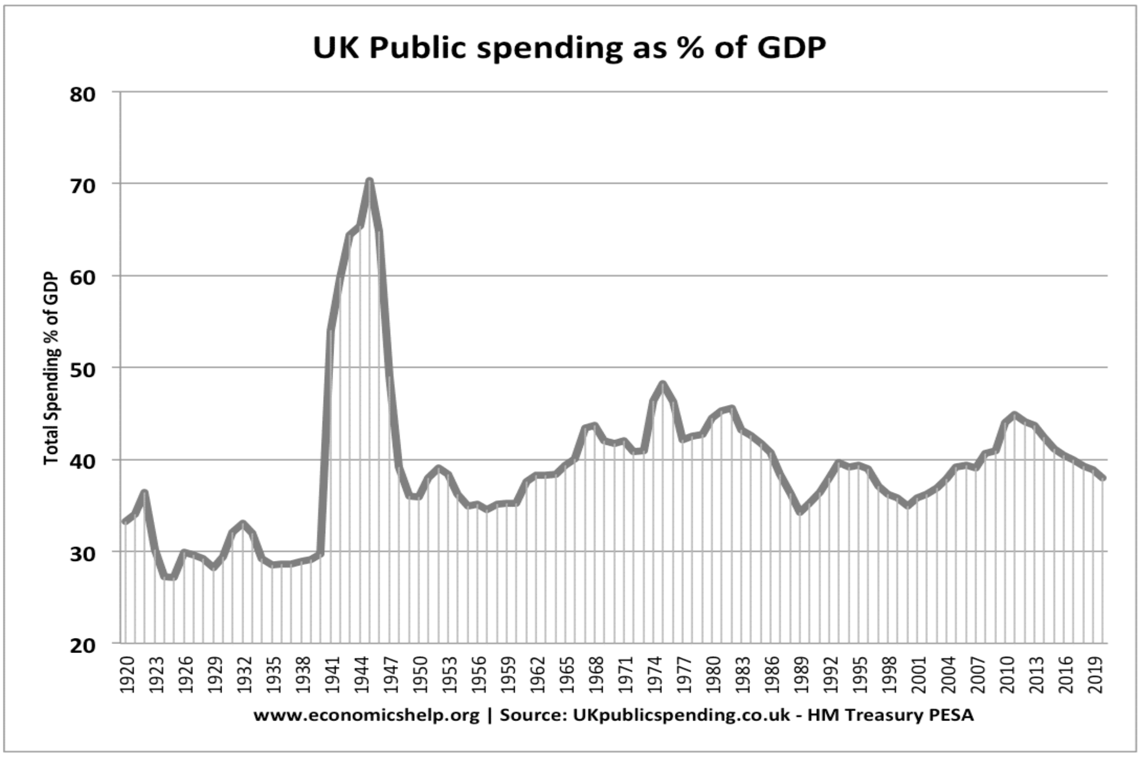


1.2 IMPACT OF INCREASING SPENDING: A CASE STUDY ON UK

Increased government spending is likely to cause a rise in aggregate demand (AD). This can lead to higher growth in the short-term. It can also potentially lead to inflation. Higher government spending will also have an impact on the supply-side of the economy – depending on which area of government spending is increased. If spending is focused on improving infrastructure, this could lead to increased productivity and a growth in the long-run aggregate supply. If spending is focused on welfare benefits or pensions, it may reduce inequality, but it could crowd out more productive private sector investment.

The impact of an increase in government spending (and hence AD) depends on the situation of the economy.





It is more likely that the rise in taxes will negate the impact of rising government spending. This would leave Aggregate Demand (AD) unchanged. However, it is possible increased spending and tax rises could lead to an increase in GDP. In a recession, consumers may reduce spending leading to an increase in private sector saving. Therefore, a rise in taxes may not reduce spending as much as usual. The increased government spending may create a multiplier effect. If government spending causes the unemployed to gain jobs, then they will have more income to spend leading to a further increase in aggregate demand. (e.g., construction workers employed by government increase spending in pubs and transport, causing other sectors of the economy to benefit from the government spending). In these situations of spare capacity in the economy, government spending may cause a bigger final increase in GDP than the initial injection.

However, if the economy was at full capacity, the increased government spending would tend to crowd out the private sector leading to no net increase in AD from switching from private sector spending to government sector spending. Some economists would argue increasing government spending through higher taxes would lead to a more inefficient allocation of resources as governments tend to be less effective in spending money. Another consideration is that an economy may grow at 2.5% a year. If there is higher government spending, this growth rate continues. But the growth is not due to the rising government spending. The government spending just fails to change the growth rate.

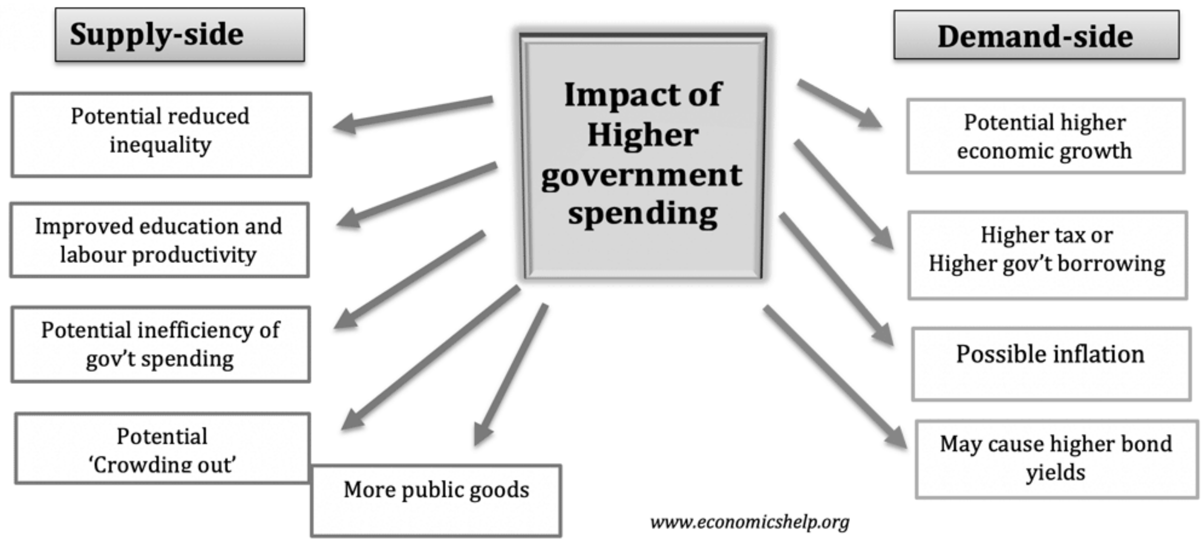
PUBLIC EXPENDITURE AND BUDGETING CYCLE

2.1 CANONS OF PUBLIC EXPENDITURE: BY PROF. FINDLAY

The following canons of public expenditure have been laid down by Prof. Findlay Shirras:

- *Canon of Benefit*: This canon suggests that every public spending must ultimately be used for the cause of social benefit — general well-being of the common people. It, thus, implies that State spending should confer benefits on the community at large rather than on an individual group or section. It means public funds should be spent in such directions which pursue common interest, and promote general welfare.
- *Canon of Economy*: It implies that public expenditure should be incurred carefully and economically. Economy here means avoidance of extravagance and wastages in public spending. Public expenditure must be productive and efficient. Hence, it must be incurred only on very essential items of common benefit, without duplication, in a way that involves minimum cost. An efficient system of financial administration is, therefore, very essential in any country.
- *Canon of Sanction*: This canon suggests that no public spending should be made without the approval of proper authority. The procedure for sanction in public expenditure is required for the enforcement of economy as well as for the prevention of misuse of public funds. As a rule, therefore, money must be spent on the purpose for which it is sanctioned by the highest authority and accounts be properly audited.
- *Canon of Surplus*: This canon suggests that saving is a virtue even for the government, so an ideal budget is one which contains an element of surplus by keeping public expenditure below public revenue. In other words, it means that the government should avoid deficit budgeting in the interest of its own creditworthiness.

Besides the above stated canons of public expenditure, a few more canons are also suggested by some writers. For instance, the *Canon of elasticity* has been stressed which implies that the spending policy of the State should be such that changes and flexibility must be possible in the expenses according to the changes in the requirements and circumstances. The *Canon of productivity* is also advocated by many. This implies that public spending should tend to encourage production in the economy. That means a large part of public expenditure must be allocated for developmental purposes.



2.2 PRODUCTIVE SPENDING AND GROWTH: AN ANALYTICAL FRAMEWORK

In this section we put forward an analytical framework to study the relationship be- tween public spending, growth and the long-run dynamics of the ratio of public debt to GDP. We concentrate on the distinction between productive and unproductive public expenditures and their different impact on the economy's rate of growth and the dynamics of the public debt ratio.

Our analytical construct is 'frugal', in the sense that we essentially concentrate on the analysis of the long-period equilibrium conditions for a closed economy with a public sector that spends on goods and services and levies taxes. No particular hypotheses are made about the investors and consumers' behaviour.

Our main conclusion is that, as a consequence of an adequate number of public re- sources being devoted to productive expenditures, the economy can realise a growth path characterised by a stable, or declining, public debt ratio, even though the government keeps on running primary deficits.

Productive and unproductive public expenditures. Let us start by providing the definition of productive and unproductive public expenditures that we use in the present context.

Productive expenditures: all those government expenditures that directly affect the economy's long-run growth rate by determining an increase in the rate of capital accumulation, which is interpreted as inclusive of both physical and human capital. Public productive expenditures have an impact on the rate of capital accumulation either directly or through their effect on private investment. Capital productive expenditures evidently contribute directly to the growth of the economy's productive capacity; but, more in general, productive expenditures can affect the productive capacity by favouring a larger amount of private investment and its efficiency, like for example it is the case of investment in infrastructures.

Unproductive expenditures: they are all those government expenditures that do not produce direct effects on capital accumulation and growth.

Year	Rs. Crore			As a percentage of GDP	
	Development Expdt	Non-development Expdt	Total Expenditure	Development Expdt	Non-development Expdt
1995-96	1,39,246	1,53,858	2,93,104	11.7%	13.0%
1996-97	1,57,757	1,67,857	3,25,614	11.5%	12.3%
1997-98	1,78,342	1,94,631	3,72,973	11.7%	12.8%
1998-99	2,06,603	2,39,377	4,45,980	11.9%	13.7%
1999-00	2,37,931	2,79,125	5,17,056	12.3%	14.4%
2000-01	2,51,428	3,00,696	5,52,124	12.0%	14.4%
2001-02	2,74,915	3,38,676	6,13,591	12.1%	14.9%
2002-03	2,92,170	3,69,494	6,61,664	11.9%	15.0%
2003-04	3,60,766	4,01,999	7,62,765	13.1%	14.6%
2004-05	3,67,253	4,57,227	8,24,480	11.7%	14.5%
2005-06	4,41,736	4,91,905	9,33,641	12.3%	13.7%
2006-07	5,40,954	5,45,638	10,86,592	12.6%	12.7%
2007-08	6,42,281	6,01,316	12,43,597	12.9%	12.1%
2008-09	7,96,570	7,22,511	15,19,081	14.1%	12.8%
2009-10	9,17,996	8,96,614	18,14,610	14.2%	13.8%
2010-11	11,03,592	10,02,103	21,05,695	14.2%	12.9%
2011-12	12,63,825	11,17,609	23,81,434	14.0%	12.4%
2012-13	14,15,272	12,33,991	26,49,263	14.0%	12.2%
2013-14	16,96,385	14,56,550	31,52,935	14.9%	12.8%
2014-15	18,79,247	16,58,258	35,37,505	14.6%	12.9%

Table 1: Development and Non Development Expenditures of the Central Government

2.3 ANALYSIS OF THE GROWTH OF PUBLIC EXPENDITURE IN INDIA

2.3.1 Size of Public Expenditure

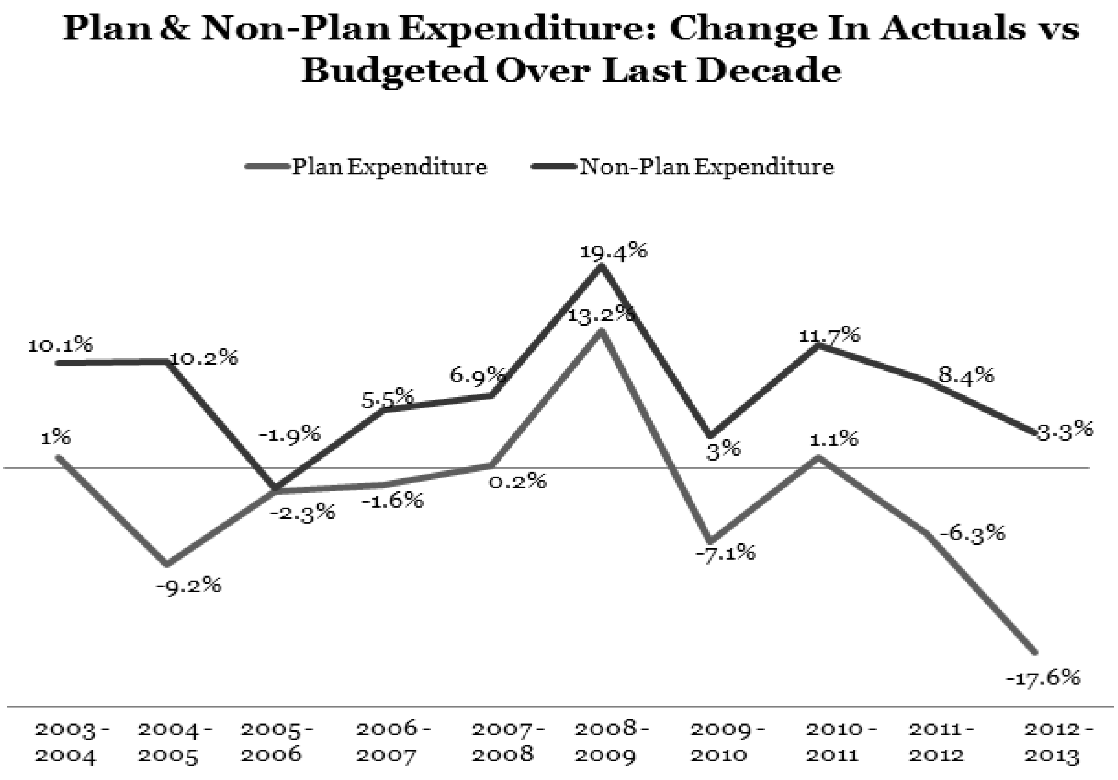
The size of the public expenditure in India, i.e., the total expenditure of the central and state governments has grown from Rs 938 crores in 1950-51 to Rs 14,85,535 crores in 2008-09 or at an average annual growth rate of 13.5 per cent. The growth of public expenditure has been almost at the same pace as that of revenue generation, which also had grown at an average annual rate of 13.9 per cent per annum over the period. Of course, all of this increase cannot be regarded as real, as a good part of it would be due to the rise in prices. But even if an adjustment is made for the rises in prices the fact remains that there has been a phenomenal increase in public expenditure.

This fact can also be brought out in another way, i.e., by relating public expenditure to GDP. Whereas GDP has increased at an annual average rate of about 4.2 per cent during this period, the proportion of public expenditure in national income has gone up from 11.1 per cent in 1950-51 to 28.3 per cent in 2008-09.

2.3.2 Plan Expenditure and Non-Plan Expenditure

The budgeted expenditure in a year is split into two parts, vis. *plan expenditure*, and *non-plan expenditure.*

- **Plan expenditure** consists of budgetary provisions for schemes and programmes that have been included in the five-year plans in which the financial allocations between different heads are made on a five-yearly basis. Within the broad parameters of budgetary provision, annual allocations are made for different schemes and programmes.
- **Non-plan expenditure** on the other hand, is a generic term which includes both developmental and non-developmental expenditure. Part of the expenditure is obligatory in nature, e.g., interest payments, pensionary charges and statutory transfers to the states. Part of the expenditure is on account of certain essential obligations of a state, e.g., defence and internal security.



Source: Union Budget, Comptroller General of Accounts, Orbis Economics Estimates

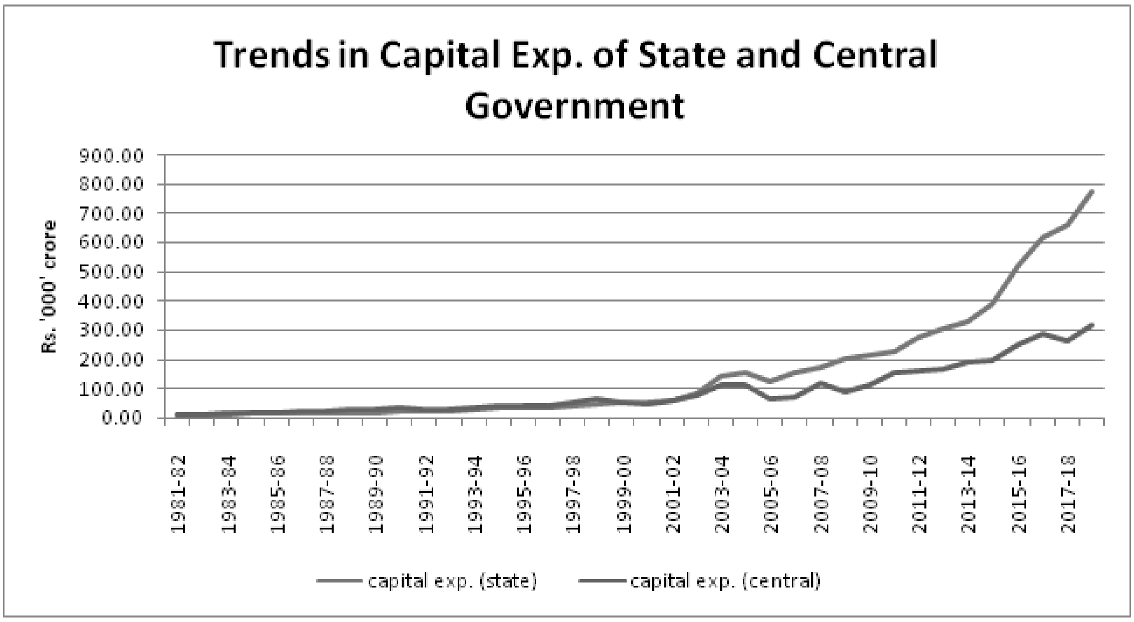
Expenditure on maintaining the assets created in previous plan is also treated as non-plan expenditure. Expenditure on continuing services and activities from levels already reached in a plan period is shifted to non-plan in the next period, e.g., expenditure on education and health services, continuing research projects, operating expenses of power stations, etc.

Thus, as more plans are completed, a large amount of expenditure on their operation and maintenance of facilities and services created gets added to non- plan expenditure besides the interest on government borrowings to finance the plan. Therefore, as the plan size grows, expenditure under the non-plan category also grows. For instance, the non- plan expenditure of the Central government amounting to Rs 76,933 crore in 1990-91 increased to Rs. 5,07,498 crores during 2008-09. However, as a proportion of total expenditure, non-plan expenditure came down to 67.1 per cent in 2008-09 from 73.1 per cent in 1990-91.

2.3.3 Classification of Public Expenditure

Public expenditure both at the centre and states can be classified into two categories, viz. *(1) developmental expenditure*, and *(2) non-developmental expenditure.*

- **Central expenditure**: Developmental expenditure of the central government includes expenditure incurred under such heads as social and community services, economic services, grants-in-aid to states and Union Territory governments for developmental expenses. Non-developmental expenditure of the central government includes expenditure incurred on defence, interest payments, etc.
- **State expenditure**: Developmental expenditure of the state governments also include expenditure incurred on social and community services, and economic services. Non-developmental expenditure includes expenditure incurred under such heads as administrative services, fiscal ser/ices, appropriation to reserves, interest payments, pensions, etc.



The proportion of developmental expenditure in total public expenditure has shown a significant increase over the years. In 1950-51, developmental expenditure formed 36 per cent of the total expenditure. In 2008-09, this proportion was estimated as 56 per cent. This indicates the growing participation of the State in developmental activities of the economy.

It should, however, be noted that the developmental schemes figure both under revenue and capital budgets. Although a larger proportion of developmental expenditure comes under capital budget, some parts of revenue budget such as subsidies do not directly pertain to developmental purposes although their indirect effects on development cannot be underrated.

2.4 PARLIAMENTARY COMMITTEES TO CONTROL PUBLIC EXPENDITURE

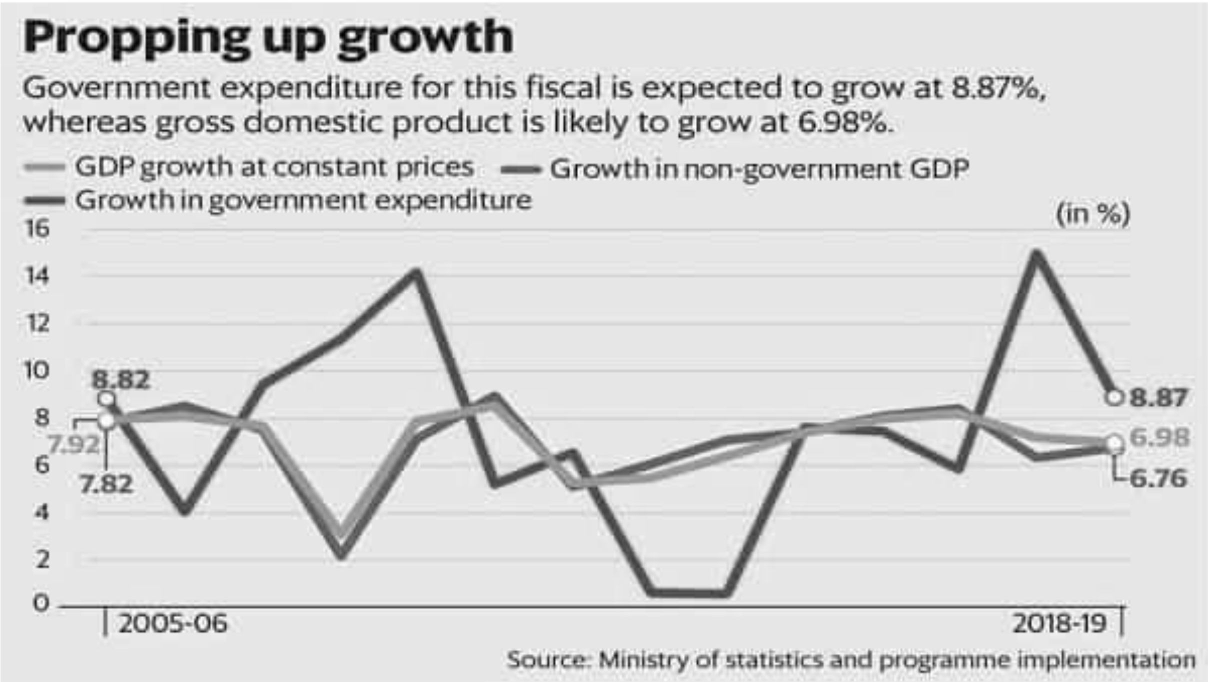
Parliament is a huge body with sovereign powers. Hence, it has to operate through its committee and the review of their reports from time to time. In the realm of these, parliamentary committees are specific and are vested with responsibilities of scrutiny of public expenditure, economy in public spending and controlling the irregularities and waste in the management of public enterprises. These committees are:

- **The Public Accounts Committee**:
  The function of the Committee as embodied in the rules of procedure and conduct of business is to satisfy itself that the money shown in the accounts books as having been disbursed were legally available for and applicable to the service or purpose to which they have applied or charged. The expenditure conforms to the authority which governs it. That every re-appropriation has been made in accordance with the provision made in this behalf under rules framed by competent authority.
- **The Estimates Committee**:
  The Estimates Committee suggests possible economies and if it finds that a particular policy is not leading to the expected results or is leading to waste, it brings to the notice of the Lok Sabha about the change. It prepares its plan of work for the year and may constitute sub-committees to examine matters.
- **Committee on Public Undertaking**:
  It is a fact-finding committee and its function, essentially, is to help Parliament to have a more effective annual debate on the working of the public undertakings. The committee has submitted scores of reports which constitute a rich mine of information to evaluate the working of Public Enterprises in India in the Pre LPG era.
- **Standing Committees**:
  The committees have extensive powers to summon and grill public servants. These committees make the government departments more accountable. They screen legislation, assess policy statements and verify the claims made by the departments in their annual reports. Combining the British and the American legislative systems, the function of the Indian parliamentary standing committees is to scrutinise the demand for grants made by various ministries.

PUBLIC EXPENDITURE AND ECONOMIC GROWTH

3.1 ANALYIS OF GOVERNMENT EXPENDITURE IN INDIA'S GROWTH

At the most basic level, GDP of an economy is the sum of private consumption expenditure, investment, government expenditure and net exports (exports minus imports). An increase in any of these pushes up GDP.



Government expenditure does not make up for a large part of GDP. Data over the years suggests that it typically accounts for 10-11% of GDP.

Take a look at the above chart. The government expenditure for 2018-19 fiscal grew at 8.87%, whereas GDP was at 6.98%. In 2017-18, government expenditure grew at 14.97%, while GDP grew at 7.17%. So, an increase in government expenditure basically pumped-up GDP growth to a large extent in 2017-18 and to some extent in 2018-19.

The last time growth in government expenditure was faster than overall GDP growth for two consecutive years or more was between 2007-08 and 2009-10. This was the period before, during and after the breakout of the 2008 financial crisis, when Wall Street investment bank Lehman Brothers went bust, leading to a global economic slowdown. In 2008-09, overall GDP growth was 3.09%, whereas growth in government expenditure was 11.36%. Of course, 2017-18 and 2018-19 have been nothing like the global financial crisis years, but economic growth has still required a major push from the government.

The non-government part of GDP constitutes around 90%. In the 2018-19 fiscal, it grew by 6.76%; in 2017-18, it grew at a rate of 6.32%. The last time the non-government part of the economy grew slower than the overall GDP for two consecutive years or more was between 2007-08 and 2009-10, that is, during the period of the financial crisis. This is another good indicator of the fact that all has not been well with the Indian economy for the last two years.

The rise in government expenditure is not pushing up fiscal deficit because a lot of revenue, as well as capital expenditure of the government, is now kept outside its budget. The Comptroller and Auditor General (CAG) highlighted this in a report. This style of pushing up growth by raising government expenditure is not sustainable. In 2017-18, government expenditure went up 14.97%, while GDP growth was at 7.17%. In 2018-19, it was likely to rise to 8.87% and GDP growth was expected to be at 6.98%.

3.2 CAUSES OF GROWTH IN PUBLIC EXPENDITURE IN INDIA

The continuously rising public expenditure can be explained in terms of the Wagner’s Law. According to the Wagner’s law, there exists a causal relationship between government expenditure and economic development. The law specifies that: ‘during the course of economic development, government expenditure increases more than proportionately with per capita community output’. In other words, the income elasticity of demand for government expenditure is more than one. The underlying explanation is that the very growth of the economy gives rise to such complexities that the government has to incur increasing expenditure to deal with them. Wagner distinguished three types of activities, which cause an increase in government expenditure.

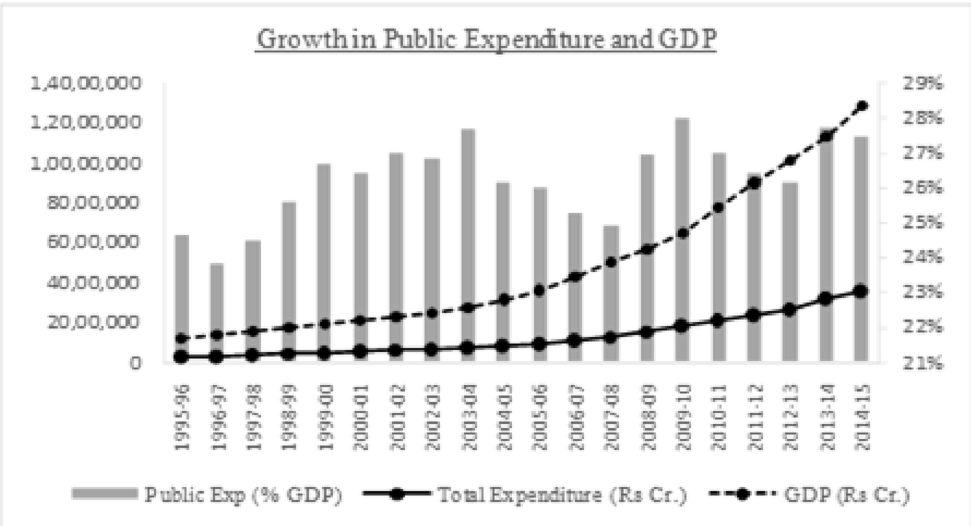


Figure 1

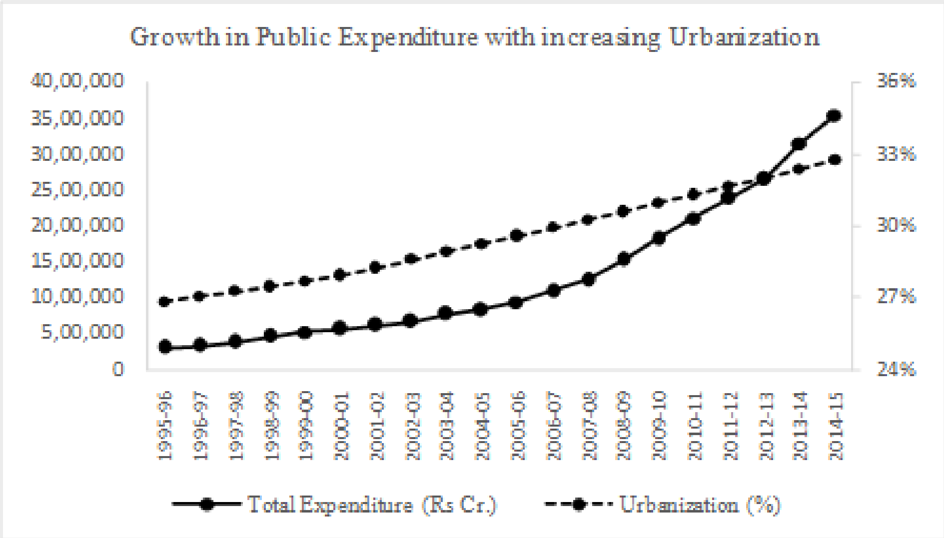


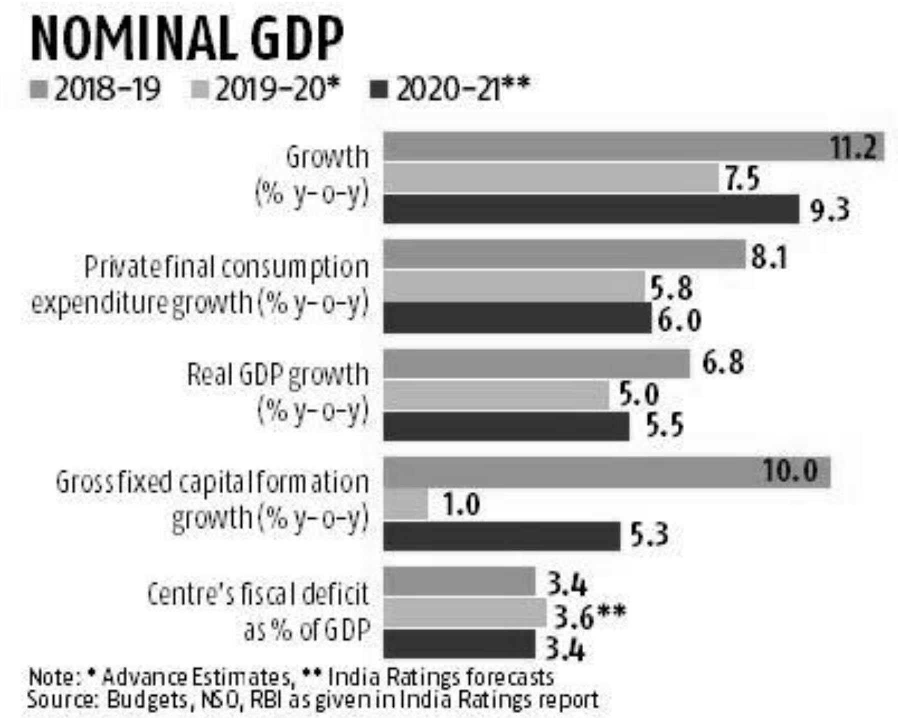
Figure 3

These are: *Maintenance and enforcement of internal law and order*; and *Participation in material production*; and *Provision of social services.*

Each one of the above pushes up the expenditure for different reasons. The first one increases expenditure because government has to ensure the maintenance and improvement of the quality of services it provides. The second one increases expenditure because government has to create a climate conducive to economic growth by entering into material production which private sector would not undertake on its own. The third one pushes up expenditure because government alone has the ability to provide such services satisfactorily.

In addition, more recent research in this area has identified other factors like demographic changes, higher income elasticity of public goods, increasing cost of government production, etc. as responsible for growing public expenditure of the government.

All the above-mentioned factors are interrelated suggesting that the sphere of government activity in developing economies like India is rising. The type of the mixed economy that India has adopted has opened up multiple avenues of government action ranging from direct participation in production (as an entrepreneur) to the exercise of regulatory and promotional measures (via taxes and subsidies). The objective of these activities would, therefore, range from the provision of social overhead capital to achieving of social and economic equality in the economy.



3.3 LIFTING THE ECONOMY BY SPENDING MORE: INDIAN CASE STUDY

3.3.1 Economic Stimulus

During an economic slowdown, as the one India is experiencing now, corporates as well as consumers tend to reduce spending. Individuals don't have sufficient confidence in their economic future and corporates don't see enough demand that would justify spending and expansion. Some corporates have a lot of debt and are not in a position to take on more debt and expand. This slows down growth. In this scenario, the government needs to step in as the spender of last resort and loosen its purse strings to stop growth from slowing further—or so the theory goes.

Overall Stimulus provided by Atmanirbhar Bharat Package

SN	ITEM		(Rs. Cr.)
1	Part 1		5,94,550
2	Part 2		3,10,000
3	Part 3		1,50,000
4	Parts 4 and 5		48,100
		Sub-Total	**11,02,650**
5	Earlier Measures incl PMGKP	(earlier slide)	1,92,800
6	RBI Measures (Actual)		8,01,603
		Sub Total	**9,94,403**
		GRAND TOTAL	**20,97,053**

3.3.2 Economic position of government and GST collection

The government needs more money to spend more than it has budgeted for. However, it is not earning enough tax revenue—at least, nowhere near what it expected to when the budget for FY20 was presented. The gross tax revenue between April and August (2019) has grown just 4.2%. If the expenditure the government has budgeted for needs to be met, the gross tax revenue needs to rise by 18.3%. Clearly, growth in tax revenue has slowed dramatically. Nowhere is this more visible than in the collection of goods and services tax (GST), which has collapsed. This is another indicator of slowing consumer demand.

The government earned ₹91,916 crore through the goods and services tax for the month of September. These collections were the lowest in 19 months. The GST collected in September was on the basis of the economic activity in August, which saw a dramatic decline.

3.3.3 State of economic activity and measures to boost growth

Financial services company Nomura said in a recent research report that economic activity in August 2019 was weaker than the economic activity seen during the global financial crisis in late 2008. This suggested that gross domestic product (GDP) growth in India during the July-September (2019) period was going to be lower than 5%.

Overall government expenditure in FY18 and FY19 went up by 15% and 9.3% (adjusted for inflation), respectively, at a time the economy was growing by 7.2% and 6.8%, respectively. From Q1 FY20, the economy grew by 5%—private consumption expenditure went up just 3.1% and government spending grew 8.9%. Over the last couple of years, the jump in government expenditure has kept growth going. If expenditure is increased, it will push up interest rates.

CONCLUSION

By using a simple analytical framework, we have established a functional relation between the composition of public spending and the behaviour of the ratio of public debt to GDP. Our main conclusion is that an economy, in the long run, can experience a stable ratio of the public debt to GDP despite persistent government primary deficits. In this context, the distinction between productive and unproductive public expenditures is crucial. We show that a stable debt ratio is compatible with primary deficits if the latter are mainly devoted to financing productive expenditures that have a positive impact on the rate of growth as well as on private investment.

We test our analytical results empirically by considering the Indian case. India, in fact, appears to be a country characterised by high rates of growth accompanied by persistent government deficits. Our empirical analysis shows that, while private capital formation remains crucial for the economy's growth, the dynamics of the ratio public debt/GDP can be stabilised only if public spending is devoted to public investment to a significant extent. In the absence, or little relevance, of public investment, the effects of private investment on the debt ratio are not significant. Thus, contrary to the notion of public investment 'crowding out' private investment, the two must work together in the long run to stabilise the public debt trajectory.

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