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FINANCIAL ADMINISTRATION

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Subject: FINANCIAL ADMINISTRATION **Credit: 4**

SYLLABUS

Financial Administration: Basic and Objectives
Centre-State Financial Relations-II, Centre-State Financial Relations-I, Mixed Economy, Nature and Scope of Financial Administration, Objectives and Principles of Financial Administration

Budgeting and Budgetary Systems-I
Indian Budgetary System, Government Budgeting: Principles and Functions, Fiscal Policy, Equity and Social Justice

Budgeting and Budgetary Systems-II
Zero Base Budgeting, Performance Budgeting, Public Expenditure: Theories and Growth, Classification of Government Expenditure

Resource Mobilization
Public Debt Management and Role of Reserve Bank of India, Deficit Financing, Sources of Revenue: Tax and Non-Tax

Investment of Public Funds
Economic and Social Appraisal, Financial Appraisal

Financial Control
Executive Control, Legislative Control, System of Financial Committees

Accounts and Audit
Role of the Comptroller and Auditor General (CAG), Accounting System in India, Auditing System in India

Financial Administration of Public Enterprises and Local Finance
Financial Autonomy and Accountability of Public Enterprises, Financial Administration of Public Enterprises, Financial Administration of Rural Governments, Financial Administration of Urban Governments

Suggested Readings:

1. Union Budgets And Financial Administration by Raj Shekhar Singh
2. Financial Administration and Control by Raymond A. Cox 3. Financial Administration: Specialist Units by Carol Carysforth
3. Public Financial Administration: A Study Of The Financial And Accounting Practices Of Public Authorities by V.M. Levy

CHAPTER 1

FINANCIAL ADMINISTRATION: BASIC AND OBJECTIVES

STRUCTURE

- Learning objectives
- Centre-state financial relations-II
- Centre-state financial relations — I
- Mixed economy
- Nature and scope of financial administration
- Objectives and principles of financial administration
- Review questions

LEARNING OBJECTIVES

After going through this unit, you should be able to:

- Explain the constitutional provisions concerning the division of functions and possessions and other financial powers flanked by the Union and the States.
- Explain the meaning of the concept of federation.
- Trace the development of mixed economy in India through examining several Industrial Policy Resolutions.
- Discuss the meaning, importance of financial administration.
- Explain the nature of financial administration.
- Discuss the objectives of fiscal policies aimed at securing sure social and economic goals as envisaged in modern public policies.

CENTRE-STATE FINANCIAL RELATIONS-II

DIVISION OF FUNCTIONS AND POSSESSIONS UNDER THE CONSTITUTION

Federation or Union

The vital characteristic of a federation is that the powers are so divided that the central and state governments are each within its sphere coordinate and independent. India is a federation of States. The Constitution of India which came into force in 1950 provided for a clear-cut division of functions and revenue possessions flanked by Union and States. The Seventh Schedule of the Constitution contains a detailed sharing of functions flanked by the central and state governments in the form of three lists i.e., union, state and concurrent lists. The functions of the central government are specified in the Union list which comprises defense, atomic energy, foreign affairs, railways, national highways, posts and telegraphs, currency and coinage, foreign exchange, inter-state trade and heavy and vital industries.

The functions assigned to the states as enumerated in the state list contain law and order, police, administration of justice, education, medical and public health, agriculture, irrigation, power, forests, fisheries, cooperatives, rural and community development and slum clearance. Separately from the union and state lists, there is a third list recognized as the concurrent list. Functions of an inter-state nature, such as commercial and industrial monopolies, labour disputes, social legislation, social security, and economic and social planning have been placed under the concurrent legislative powers of the central and state governments. In the event of a conflict flanked by the laws of the central and state governments over a concurrent area, the former i.e. the central law prevails.

The Constitution describes India as a 'Union of States'. A motion to designate India as a 'Federation of States' was rejected through the Constituent Assembly. Dr. B.R. Ambedkar put it very succinctly therefore;

- "... Though India was to be a federation, the federation was not the result of an. agreement through the States to join in a federation and that the federation not the result of an agreement, no State has the right to secede from it. The federation is a Union because it is indestructible. Though the country and the people may be divided into dissimilar States for convenience of administration, the country is one integral whole, its people a single people living under a single imperium derived from a single source. The Americans had to wage a civil war to establish that the States have no right of secession and that their federation was indestructible."

The Drafting Committee thought that it was better to create it clear at the outset rather than to leave to speculation or to dispute.

Financial Powers

In effecting a division of possessions, the Constitution gives for a strong centre. The Constitution ensures the supremacy of the action of the Union

Government over the fairly comprehensive Union list as also over concurrent jurisdiction. Allocation of the heads of taxation flanked by the union and the states is based on the broad principle that taxes which are location-specific and relate to subjects of local consumption have been assigned to the states.

Those taxes like for instance Income tax which are of inter-state significance and where the place of residence is not a correct guide to the true incidence of tax have been vested in the union. This clear-cut division of heads of taxation flanked by the union and the states has minimized the scope for conflicts and litigation flanked by them. The taxes over which the union has legislative jurisdiction can be classified as follows:

- Taxes which are to be levied and composed through the Union and the whole proceeds there from are to be retained through it. These contain corporation tax and customs duties.
- Taxes which are levied and composed through the Union but proceeds are shared with the States. These are income tax, and excise duties.
- Taxes which are levied through the Union but composed and retained through the States. These are estate duties and terminal taxes on goods and services.
- Taxes which are levied through the Union but composed and retained through the States. These are excise duties on medicinal and toilet preparations (containing alcohol), opium, etc.

In addition, there are exclusively state taxes, i.e., taxes levied and composed through the states and appropriated through them. This category comprises land revenue, taxes on Article 286 of the Constitution forbids taxation through states of

- Imports into or exports from the territory of India;
- Inter-state trade; and
- Sale of goods declared through the Parliament through law to be essential for the life of the community.

The property of the union is exempt from state taxation. The property and income of the states are exempt from the union taxation. In addition to the provisions for tax-sharing, Article 275 of the Constitution gives for both general purpose and specific grants. Though, it has been left to the Parliament to decide which states are in need of grant assistance and to what extent subject to the recommendations of the Finance Commission.

The borrowing powers of the central and state governments are regulated through Articles 292 and 293 of the Constitution. The central government can borrow on the security of the Consolidated Fund of India within and outside the country subject to the limits, if any, specified through the Parliament. The state governments can borrow usually only within the territory of India with the consent of the central government. The central government may also provide loans to the state governments, subject to such circumstances as are laid down in a law of Parliament.

If the President of India is satisfied that a situation has arisen where the financial stability or credit of India or any part of the territory thereof is threatened, the President may declare financial emergency under Article 360 of the Constitution. In these abnormal and emergent circumstances, both collection and sharing of revenues in state governments are made through the central government or state governments as decided through the Parliament.

Allocation of financial powers and possessions flanked by the centre and the states is indeed the mainly vital and yet the mainly hard task. The revenues of the federations have undoubtedly been rising. In some federations like the United States of America, where the federation and the states have concurrent taxation powers, there has been a lot of litigation which is inherent in the exercise of overlapping powers. In Australia and Canada, negotiations and agreements played a significant part in determining the shares in the proceeds of taxes. In such situations, it is political expediency rather than time-honored conventions which come handy in resolving conflicts. With regard to allocation of financial possessions flanked by the centre and the states as said earlier there are constitutional provisions that:

- The states are entitled to a important share in federal taxes;
- The proceeds of sure taxes levied through the centre are totally assigned to the states; and
- There is a system of grants-in-aid to the states.

One criticism that is often voiced concerning the allocation of financial possessions flanked by the centre and the states in India is that elastic and substantial sources of revenue have been assigned to the centre whereas the states, which have been entrusted with significant developmental and welfare functions, have been entrusted with inelastic and inadequate sources of revenue.

THE FINANCE COMMISSION

Finance Commission and Planning Commission are the two significant bodies through which fiscal transfers flanked by the centre and states are affected. As we have said earlier, in the allocation of possessions flanked by the centre and the states, major elastic sources of revenue have been assigned to the centre. The fact that the Constitution gives for obligatory sharing of income tax receipts and permissive sharing of Union Excise Duties, is an implicit acknowledgement of the inadequacy of 'States' sources of revenue. The Constitution, though, did not specify the share of the state or its inter se sharing. The Constitution, so, gives for the setting up of a Finance Commission periodically for this purpose. The functions of the Finance Commission are to create recommendations to the President in respect of:

- The sharing of net proceeds of taxes to be shared flanked by the Union and the States and the allocation of shares of such proceeds, in the middle of the States
- The principles which should govern the payment of the Union grants-in-aid of the revenue of the States; and
- Any other matter concerning financial relations flanked by the Union and the States.

The Finance Commission is a quasi-judicial body and it acts independent of the centre and the states. The specific conditions of reference of each Finance Commission are drafted through the Ministry of Finance at the Centre. The state governments are not consulted in the matter. Practical difficulties in working out a consensus approach, amongst dissimilar states at times ruled through dissimilar political parties with dissimilar viewpoints, seem to have discouraged consultations with the state governments.

In the absence of a clearly specified and constitutionally recognized institutional mechanism for revenue-sharing flanked by the federal and state governments in some of the significant federations, numerous adjustments had to be resorted to. In the first place, because of concurrent taxation powers in federations like USA, Australia and Canada, "which stage uses what type of tax and what extent has been decided more through custom and negotiation, incorporated in statute, or agreement, than through Constitutional provision". In USA, at least, the tax system which came to be developed over the years is described to be uncoordinated and overlapping. The other federations have faced similar or worse troubles.

The Finance Commission in India on the other hand, because of its constitutional status constitutes a unique arrangement. Because of this status and the fact of being an expert body, the devolution of possessions i.e. tax-sharing and grants-in-aid has been removed from the arena of political bargaining. Even though the Commission is an advisory body, its recommendations, beside with the action taken thereon, have to be placed before the Parliament. According to the Constitution, the Finance Commission should consist of a Chairman and four other members. According to the Finance Act, 1951, the Chairman shall be a person with experience in public affairs. The four members should have been or be qualified to be appointed as Judges Of the High Court, or should have specialized knowledge of economics, financial matters or finance and accounts of the government. The constitutional status accorded to it and its functioning as a semi-judicial expert body has earned for the Finance Commission high regard of the Union and the States.

The Approach

In India, so far ten Finance Commissions have been set up and they adopted a common approach with regard to fiscal transfers from centre to states. Some uniform principles or thoughts have been kept in view through the Finance Commissions in creation their recommendations. The first Finance Commission laid down sure principles as follows: Firstly, the additional transfer of possessions from the centre necessity is such as the centre should bear without undue strain on its possessions taking into account its responsibility for such vital matters as the defense of the country and the stability of the economy. Secondly, the principles of sharing of possessions flanked by the states and the determination of grants-in-aid necessity are consistently applied to all. Thirdly, the scheme of sharing should attempt to lessen the inequalities flanked by the states (First Finance Commission Report).

The First Finance Commission further observed: “It is not the purpose of any system of grants-in-aid to diminish the responsibilities of the State governments to balance their own budgets. The method of extending financial assistance should be such as to avoid any suggestion that the Central Government had taken upon themselves the responsibility for helping the states to balance their budgets from year to year.”

The Eighth Finance Commission gave primacy to national interest as a whole. Their paramount consideration was reconciling the need to accelerate the development of backward states without hindering the further development of the more advanced ones. The commission, so, took steps to reduce the local imbalances flanked by the states in addition to covering revenue gaps.

The Ninth Finance Commission (Second Report) also observed:

- “The manner of transfer of possessions should be such as to preserve fiscal autonomy of the states and to promote fiscal responsibility on the part of both the centre and the States. Central transfers invariably involve questions of inter-state equity and such equity can be attained in a system of federal transfers only if fiscal prudence, tax effort and growth impulses are not penalized.”

Resource Transfers

Share of Income Tax: Article 270(1) of the Constitution gives for sharing of taxes on income flanked by the union and the states, in such manner as may be prescribed through the President after considering the recommendations of the Finance Commission. The First Finance Commission fixed the state's share of the divisible pool at 55 per cent which earlier was 50 per cent. This was progressively raised to 60 per cent, 66 per cent, and 75 per cent through the second, third and fourth Commission respectively. The sixth and seventh commissions raised it further to 80 per cent and 85 per cent respectively. The eighth and ninth Finance Commissions have retained it at that stage.

Share of Excise Duties

This is another tax whose proceeds are shared through the union with the states. Under Article 272 of the Constitution, union duties on excise other than that on medicinal and toilet preparations as mentioned in the union list are levied and composed through the centre, but if Parliament gives through law may be shared flanked by the centre and the states. The states' share has been successively increased. The growth is mainly due to:

- Augment in the number of commodities taxed
- Augment in rates
- Rise in prices; and
- Augment in the output of taxable commodities.

The states' share in divisible pool of excise duties was 40 per cent of only three commodities. The share was raised through the second and third commissions and fourth commission raised the share to 20 per cent of all commodities. The fifth and sixth finance commissions maintained the stage, seventh commission raised it to 40 per cent of all commodities, eighth raised it to 45 per cent of all commodities. Ninth Commission retained it at that stage.

Grants-in-aid

Under Article 280 of the Constitution, the Finance Commissions have been given the right of creation recommendations concerning the payment of grants-in-aid of the revenues of the states out of the Consolidated Fund of India. Article 275 gives for the payment of such funds to the states which are actually. in need of assistance. But the controversies that arise with regard to grants-in-aid are because the term 'need' has not been clearly defined in the Constitution. The first Finance Commission listed six principles of grants-in-aid which have been followed through later Finance Commissions also with varying degrees of emphasis. These are:

- Budgetary needs;
- Tax efforts;
- Economy in expenditure
- Standard of social services.

- Special obligations; and
- Broad purpose of national importance.

The first Finance Commission recommended specific grants for jute producing states, special grants to eight states for promoting primary education. The second Finance Commission did not recommend the grants for primary education. The third Finance Commission tried to widen' the scope of the grants-in-aid through including grants for plan outlays also. It was of the view that total impact of grants-in-aid should be of an order which would enable the states, beside with the surplus out of devolution, to cover 75 per cent of the revenue necessities of their plans. Quite contrary to this, the fourth Finance Commission confined itself to non-plan revenue expenditure and therefore limited the scope of Article 275 to cover only. the non-plan grants. Similar views were expressed through the fifth commission.

The sixth Finance Commission recognized sure administrative services such as general administration as primary education, medical and public health, welfare of scheduled castes, scheduled tribes and other backward classes as to be of crucial importance. It recommended that those states whose expenditure on these items in per capita conditions was below the all states average should be enabled to come upto such an average through the last year of the award. Such additional provisions were taken into account for determining quantum of overall plan revenue gap.

The seventh Finance Commission took the view that grants-in-aid should only be a residuary means of assistance and should be used not merely to fill in the uncovered revenue gaps but should be used to narrow down the disparities in the standards of administrative and social services of the states. The eighth Finance Commission broadly agreed with the views of the seventh Finance Commission. The successive Finance Commissions have, so, broadly followed the residuary financial assistance approach in recommending the grants-in-aid.

The vital objectives underlying the ninth Finance Commission's approach and methodology were:

- Phasing out the revenue deficit of the Centre and States in such a manner that the deficit is reduced to zero or a relatively small figure through 31st March, 1995;
- Equity in the sharing of fiscal possessions both vertically and horizontally; and
- Promotion of fiscal discipline and efficiency in the utilization of possessions.

The Finance Commissions have played a very significant role in the field of federal finance, in spite of sure limitations under which they had to function. Some of these limitations contain:

- Constitutional limitations as it have to function under the given framework.
- Constraints imposed through the Union on the Finance Commission through prescribing sure conditions of reference.
- Non-implementation of significant recommendations of the Finance Commission through the union government.
- Troubles arising out of the methodologies followed through the Finance Commission.

Some of the states have made suggestions for improving the working of the Finance Commission. These have been summarized through the Sarkaria Commission as follows:

- The functions of the Finance Commission are enlarged. It should also consider plan and other transfers and/or undertake comprehensive annual/periodical reviews of the financial performance of the Union and State Governments.
- The Finance Commission should be made a permanent or standing body to cope with enlarged responsibilities.
- The coordination flanked by the Finance Commission and the Planning Commission should be improved so that an integrated view of the flow of Central assistance to the States becomes possible.
- It should be provided with a permanent and well-equipped secretariat to carry out studies and maintain operational stability for the benefit of the subsequent Finance Commissions.

As regards the conditions of reference being given through the centre, it has already been pointed out earlier that differences of opinion flanked by the states themselves do not allow a consensus to emerge. The union government, though, initiated steps to secure the representation of states on an official stage committee set up to finalize the conditions of reference. This arrangement is measured adequate for the purpose.

On the non-implementation of the recommendations of the Finance Commissions, the Sarkaria Commission has listed three such occasions' upto Seventh Finance Commission which the central government could not implement for several reasons. Though, the criticism that the union government did not implement the report of the eighth Finance Commission in the first year itself has been found to be valid and the Sarkaria Commission calls it rather unfortunate. It hopes such occasions will not arise in future.

There has been a long-standing suggestion that the Finance Commission should consider plan and other transfers in addition to non-plan revenue transfers. While conceding that plan transfers could be measured through them, the fourth Finance Commission observed that "the importance of planned development is so great that there should not be any division of responsibility in regard to any element of plan expenditure. The Planning Commission has been specially constituted for advising the Government of India and the State Government in this regard. It would not be appropriate for the Finance Commission to take upon itself the task of dealing with the State's new plan expenditure"

The suggestion concerning a permanent Finance Commission did not find favor with the Sarkaria Commission which felt an active involvement of the Finance Commission in determination of annual transfers would be at the cost of objectivity. There is no denying the fact that the Finance Commissions have done an impressive amount of work in the field of federal finance, which has been better recognized as the Indian Finance Commission's approach to federal finance. Inspite of the many limitations in their approach and methods, they have on the whole succeeded in maintaining the vital equilibrium in the finances of the state governments.

THE PLANNING COMMISSION

As said earlier the Planning Commission is another significant body which has a significant place in Centre-State financial relations. The genesis of economic planning in India necessitated the introduction of plan assistance to states to enable them to undertake several developmental programmes envisaged in the five year plans. The responsibility for taking decisions and implementing them rests with the union and the state governments. The resolution emphasized the need for "adequate coordination" flanked by the development schemes initiated through the union and the states and for comprehensive planning based on a careful appraisal of possessions and essential circumstances of progress.

The broad functions of the Planning Commission contain:

- Assessment of material, capital and human possessions;
- Formulation of a plan for their mainly effective and balanced utilization;
- Determination of priorities and allocation of possessions for completing each stage of the plan;
- Determination of machinery for securing successful implementation of the plan;
- Appraisal of progress and recommending adjustments in policies and measures throughout the execution of the plan; and

- Creation of interim and ancillary recommendations on current development policies, measures, etc...

From the very beginning, the Prime Minister has been the Chairman of the Commission. The Deputy Chairman is an eminent person, usually a politician, holding the rank of a Cabinet Minister. There are two kinds of members of the Planning Commission in addition to the Minister for Planning. There are a few full-time members who are eminent public persons, economists, social scientists, technical experts or administrators. In addition, the Commission has as its members, a few Cabinet Ministers like the Finance Minister, Defense Minister, etc., who attend only very significant meetings of the Commission. A large secretariat has been recognized to assist the Planning Commission in its work.

The Planning Commission has Advisers (State Plan) who perform a very significant role vis-à-vis the States. On the one hand, they assist the Planning Commission in finalizing the state plans and on the other, in monitoring the progress of several development programmes in the states. They also interact with the state governments and assist them in resolving these troubles in implementation of the plan. They are therefore expected to function as an active link flanked by the Planning Commission and the state governments.

National Development Council

The setting up of the National. Development Council in August 1952 on the suggestion of the Planning Commission itself may be regarded as the mainly important step for promoting understanding and consultation flanked by the Union and the state governments on planning and common economic policies. It was assigned the three significant functions of (i) reviewing the working of the National Plan from time to time; (ii) considering significant questions of social and economic policy affecting national development, and (iii) to recommend measures for the attainment of the aims and targets of the national plan. Presently, besides the Prime Minister who is the Chairman, its members contain the Chief ministers of all the States and Union Territories, Ministers of the Union Cabinet. The Council can meet “as often as may be necessary and at least twice in each year”. Although the NDC is not a statutory body, its very composition gives it a unique character and its recommendations are treated with respect through the union and the state governments. It imparts a national character to the whole procedure of planning.

Devolution of Possessions

Devolution of possessions from the union to the states may be placed under three categories:

- Transfers based on the recommendations of the Finance Commission;
- Transfers through way of assistance for execution of the plans recommended through the Planning Commission, including centrally sponsored schemes; and
- Others consisting of small savings, loans, assistance for natural calamities, etc., canalized through the Union Finance Ministry.

As already stated, the transfers effected on the recommendations of the Finance Commission (also described statutory transfers) are normally determined for a period of five, years. Bulk of these transfers is unconditional and has built-in buoyancy with respect to the growth of the concerned tax receipts. These transfers accounted for about 40 per cent of the total transfers throughout the period 1951-85. A substantial part of the transfers in the second category are through way of assistance for the execution of the state plans. These accounted for 31 per cent of the total transfers from the union to the states throughout the period 1951-85. If to these transfers are added those on account of central and centrally sponsored plan-scheme, the totality of the plan transfers throughout the period 1951-85, and works out to about 41 per cent of the total transfers. The central assistance for the plans is based on the recommendations of the Planning Commission. It comprises loans and grants.

The third category of transfers is given for several purposes through the union government. These are in the form of grants and loans for relief of natural calamities, improvement of roads, upgrading salaries of teachers, etc. Throughout 1951-85, such transfers amounted to 19 per cent of the transfers. Central assistance is a significant instrument for reducing local inequalities and augmenting finances particularly of less developed states for meeting their developmental needs. Plan assistance has always been crucially significant for state plans and presently about 50 to 60 per cent of state plan outlays are met from central assistance. The amounts given as plan assistance in the form of grants (30 per cent) and loans (70 per cent) has always been determined on the basis of prescribed criteria. Nevertheless, in actual practice stronger states could get absent with a larger slice than what was their due. ’

It is often alleged that in as much as only 40 per cent of the total transfers from the Union have been effected on the recommendations of the Finance Commission, the transfers through the Planning Commission and the Union Ministries (for Centrally Sponsored Schemes) have been discretionary in character (implying subjectively arbitrary). Firstly, the Plan assistance is not mandatory on the union government. Secondly, allocation of Central assistance is subject to the approval of the National Development Council on which all Chief Ministers are represented. Thirdly, bulk of central assistance (grants and loans) is decided according to prescribed criteria, population being a major criterion, backwardness of the states, other special troubles also being other significant criteria. This is done under what is recognized as the Gadgil Formula or modified Gadgil Formula. Fourthly, in the case of centrally sponsored schemes, the pattern of financing, viz. Central assistance vis-à-vis States own contribution for several schemes is determined and recognized well in advance. As Sarkaria Commission has observed: "It is not humanly possible to derive foolproof formula which would create the totality of central transfers confirm fully to the ideal of automatic and free-from interference devolution. Some amount of flexibility and room for subjective judgment will have to be left to the concerned institutions to deal with the specific situations as they arise. What is really significant is that the institutions involved should function in a fair and non-partisan manner and take decision with due discernment and expertise which are implicitly acceptable to the states"

CENTRE-STATE FINANCIAL RELATIONS — A CRITICAL APPRAISAL

The centre-state relations in a new federation like India are quite complex. In older federations like USA, Canada, and Australia, a general acceptance of the financial relations flanked by the federal governments and the states creates for a far more smooth relationship. The general complaint against the financial relations flanked by the union and the states concerns the division of possessions.

- The states have a grievance that through and large the taxes with the Union are quite elastic whereas those left with the states are inelastic and their tax base is also narrow. Of the several taxes levied through them, only Sales Tax and to some extent the State Excise Duties have shown a degree of elasticity. Land Revenue has lost its importance. In 1951-52, it acquiesced Rs. 49 crore, comprising 21 per cent of their own tax revenue. In 1984-85, it was about Rs. 300 crore, constituting only 2.6 per cent of their own tax revenue. The states and some of the critics maintain that the Constitution has assigned to them the responsibility for development works, rural and social uplift, and structure of social overheads. Additionally, the responsibility for the maintenance of law and order, the expenditure on general administration has also gone up through leaps and bounds. Therefore there are gaps flanked by the revenue and expenditure.
- Extending the above criticism, it is held that there is inadequate devolution of taxes levied and composed through the central government, thereby reducing the finances accessible for state activities, within their sphere of responsibility.

- The heavy dependence of the states on the union for financial possessions has resulted in progressive erosion of the jurisdiction, authority, and initiative of the states in their own constitutionally defined spheres.
- The states have also to depend on the union for their share of the enormous financial possessions. These contain the banking sector and other financial institutions, foreign aid and in the last resort deficit financing supported through the Reserve Bank.
- The states are obligated to submit their five year plans, including the items within the sphere of their own responsibility to the Planning Commission created through the central government and there is interference and control through the letter over the plans of individual States. There is also a gradual decline in the relative share of State's Plan outlay in the total, rising outlay of the union on state subjects, and proliferation of centrally sponsored schemes. Therefore, the intrusive planning procedure beside with inadequate and inelastic tax base leading to resource constraints and dependence on the Union, constitute the bulk of the criticism through the states of actual operation of fiscal federalism in India.

It is not correct to say that the foregoing criticism is representative of the perceptions of all the states. In fact, according to Sarkaria Commission, mainly of the states are of the view that the existing constitutional arrangements are basically sound and there is no need to create any changes in the division of the areas of taxation envisaged in the Constitution. In fact, one state has pointed out that any transfer of taxation areas now with the union to the states would create the rich states richer and the poor states poorer. The finances of the Union Government are in none too happy a position. There is no balance from current revenues (surplus on revenue account). The Union finances have been reeling under massive deficits leading to desperate remedies in the year 1990-91 and 1991-92. More than 100 public sector enterprises are incurring losses every year. Likewise, over the years, mainly of the states have given exemptions on Land Revenue, etc., whereas the gross volume and value of agricultural production have increased manifold throughout this period. Only a few states are levying a nominal Agricultural Income Tax and that too to an insignificant extent. Agricultural Income Tax is not easy to administer. Large commercial losses have also been incurred through the public sector enterprises year after year.

The variation flanked by the states own possessions and their revenue expenditures over a period of years is not an infallible measure of the extent of their dependence on the resource transfers from the Union. The main snag is that the quantum of revenue expenditure of a state carries a substantial component relatable to revenue received through transfer from the union. This component is a variable factor which has an incremental effect on the stage of the state's revenue expenditure. The so-described narrow tax-base of the states, so, cannot be related quantitatively to the stage of their revenue expenditure as the latter itself depends upon their total revenue possessions including revenue transfers from the Union. A state government has in fact conceded after a quantitative analysis that the state's indirect taxes (Sales Tax on Passengers and Goods, Electricity Duty and Stamp Duties and Registration Fees) are fairly elastic to prices and income, but their direct taxes such as Land Revenue and Profession Tax, are highly inelastic.

If one takes note of the broad trends of revenue centralization and expenditure decentralization in other federations, one can say that usually all over the world, the federal governments have a large and rising control over revenues. This is particularly true of Australia and to a large extent of the United States of America. A more balanced situation, though, exists in Canada. A comparative revise mannered under the auspices of National Institute of Public Finance and Policy has observed.

- "We may conclude that there is a slightly higher degree of centralization of revenues in India than is usually found in the economically developed federations. But the expenditure decentralization in India is greater than in those federations. As a result, the degree of dependence on the centre, in conditions of the share of federal transfers in State's revenue is higher. Though, in so far as the transfers take place in the form of Constitutionally assigned taxes the high share of federal transfers cannot be said to be an indication of dependence"

Indebtedness of States: One of the major problem areas in Centre-State financial relations pertains to the mounting central loans. As per the Ninth Finance commission Report (second Report), total debt of states is estimated to be Rs. 899461 crore, as on 31.3.89 of which liabilities to the central government form about 63 per cent. Provident funds, reserve funds and deposits are the after that largest source of debt financing, amounting to 23 per cent of the state's total debt. Market loans constitute approximately 12 per cent of the debt and the residual is negotiated loans from public financial institutions and others. About 11 per cent of the debt is short-term.

The major cause for the rapid rise in state's indebtednesses due to investment under the plans, but more recently to the states resort to cover part of revenue expenditure. As far as market borrowings are concerned, under each five year plan, each state is allocated a share on a net basis, i.e. of repayments due in the year. The states find that their repayment obligations to the centre are absorbing a large and ever-rising proportion of fresh loans. These cut into plan possessions to a substantial extent.

The states' representation to the Ninth Finance Commission, in the middle of others, was in regard to reduction of repayment burden, write-off loans used for social infrastructure, the pattern of central plan assistance to be changed to have a higher proportion of grants, e.g. 50:70 proportions of grants to loans, etc. In channeling market loans, allocation of capital funds through the centre favors the weaker states. Had the moneys been borrowed through all the states directly from the market, the richer states would have gained in competition. The Ninth Finance Commission points out that if the centre is asked to bear the cost of borrowing funds, the amounts accessible for direct transfers to the states would be reduced. The "Central Government is not acting merely as a financial agent on behalf of the States in order to reap economies of scale in obtaining funds from the market, but also aims to fulfill sure national purposes such as promoting development and helping weaker States". It felt that the solution to the government debt problem lay in using borrowed funds efficiently and productively for capital expenditure instead of revenue expenditure. It held that, in future, scheduling of loans should be avoided and that the conditions on which the funds were lent through the centre to the states necessity be reasonable and equitable. It recommended sure debt relief measures for the states.

According to Sarkaria Commission:

- "The present division of fields of taxation flanked by the Union and the States is based on economic and administrative rationale. Levying of taxes with inter-state base and where uniformity in rates is desirable, are with the Union Government. Taxes that are location-specific are with the States. Consensus of efficiency and equity in administration of taxes and the imperative need for the Union to have adequate possessions, inter alia, to help the States with lower stage of socio-economic development and tax-potential leave hardly any scope for shifting any major sources of revenue of the States from the present allocation of areas of taxation to the Union". We may note here the views of the Administrative Reforms Commission Revise Team that "if at all, a review of taxation power is accepted out, economic thoughts would mainly almost certainly compel a shift in favor of the Union and not the other way"

CENTRE-STATE FINANCIAL RELATIONS — I

FEDERALISM — MEANING

All political systems have people with differing and often conflicting demands and dissimilar abilities to achieve them. Several groups of people in such systems have, though, common and shared concerns. On the one hand, these groups of people have separate identities and would like to retain their internal autonomy; on the other hand, their deeper socio-economic and cultural interests get articulated through the participative political processes and institutions. The function of government is to mediate flanked by dissimilar interest groups within a legal and organizational framework which binds them together. The distinctive characteristic of such a political system is that public policy decision-creation and its implementation are divided flanked by a multi-tier system consisting of two governments, i.e., a central government and a set of unit governments. The central government is recognized as the federal government and the unit governments are recognized as the state governments. The political system which is characterized through multi-stage governments is recognized as a federation. Sir Robert Garson defined a federation as: "a form of government in which sovereignty or political power is divided flanked by the central and local government so that each of them within its own sphere is independent of each other." Likewise according to K.C. Where, "Through federal principle, I mean the method of dividing powers so that the general and local governments are each within its sphere coordinate and independent." Therefore the powers of the government are divided considerably according to the principle that there is a single independent authority for the whole country (federal government) in respect of some matters and that there are independent local authorities for other matters (state governments).

The view emphasizing independence of the two stages of governments is not usually accepted. It is pointed out that "the tremendous growth of concurrent powers" in a federal form of government throughout the present century and the overlapping of government functions is so great that to suggest that the two stages of government are in fact restricted to separate spheres is quite unrealistic. The rising phenomena of concurrent powers have led to a shift of emphasis from the outdated doctrine of dual federalism to that of cooperative federalism.

VITAL CHARACTERISTICS OF FEDERALISM

Independence and Coordination

Conventional definitions of a federation usually lay emphasis on the fact that flanked by the two stages of government, there is a division of powers such that the central government is given specified functions and the states enjoy the residual (non-specified) powers. The outstanding instance of such a federation is USA. As already noted, growth of concurrent and overlapping functions as flanked by the two stages of government has led to the emergence of coordinative or cooperative federalism. The very wide use of grants-in-aid and other discretionary transfers had led to the shift absent from independence. Some writers have gone to the other extreme of suggesting that federalism has been reduced to a myth. In actual practice, centripetal tendencies tend to be the dominant characteristic and the power of the federal purse ultimately leads to the establishment of the authority of the federal government. The central government is seen to be representing the nation and as being directly responsible to the national electorate. On the other hand, the nation is the aggregate of the units which comprise it. The electorate, the members of the central parliament, the bureaucracy and politicians will tend to project demands and attitudes which originate and relate to the units. In such a situation, the central government will serve as the receptacle for the interaction of the interests of the units. In this procedure, there is bound to be a disagreement of interests, in some cases at least, flanked by the central government and the unit governments, or flanked by the dissimilar unit governments. The central government has, so, to play a mediatory role as flanked by the units. Institutional mechanisms have to be created to resolve such Conflicts particularly flanked by the central government and the state governments.

The fundamental procedure of the formation of a federation is guided through the dual consideration of self-interests of the units as also mutuality and commonality of larger objectives which bind the federating units together. Therefore the two way procedure of guarding self-interest and yet reaching out beyond it for the realization of common aspirations which may be rooted in culture, religion, race, language, internal or external security or a shared history is continually at work. This creates for cooperation, mutual accommodation, and compromise. This is the essence of a functioning federation which is characterized not so much through independence as through coordination. A federal state should combine genuine independence of action with genuine interdependence. A federal Constitution should guarantee to "each of the two stages of government independence of each other enough to enable them to engage the continuing support of important elements of the political system".

Further, there should be a constitutional and political system which links the two stages with an important degree of interdependence such that neither stage can subordinate the other to it, nor act wholly independent of the other crossways the whole range of government functions. This is indeed a daunting task, but has nevertheless to be attempted. This is the only way for imparting necessary strength as well as flexibility to an ideal federation.

Rationale for coining together

There is an inherent urge in the middle of the federating units to come together in a federation so that the political and material interests of the units can be better safeguarded through the nation that is brought into subsistence.

This procedure usually takes place through two opposite processes.

- Federation through desegregation, that is, through a procedure of decentralization — a previously existing state of a unitary character breaks up to form a federal state:
- Federation through aggregation, that is, through a procedure of centralization — a number of previously independent units agree to come together to form a federal state in which they continue to maintain their individualities. In mainly cases, federations have been brought about through the aggregation principle, i.e., through a type of compact flanked by the units existing as independent states before the formation of the federation e.g. USA. Examples of the other kind, viz., through the operation of desegregation principle, are India, Brazil, and Nigeria. In the case of federations through aggregation, the initial impulse for coming together determined the sharing of powers and functions flanked by the federal and constituent units. If the urge to unite was strong, the powers vested in the central government have relatively been quite extensive, therefore creation the central government very powerful. The needs and the rationale for federating have, so, always dictated what the character of a federation will be. In India, the central government is very strong vis-à-vis the states whereas the Nigerian federation is developing into a rather loose type of federation. The powers of unit government's vis-à-vis the federal government has varied from federation to federation.

There is a continual shift in the relative powers of the centre and the units. This shift is not peculiar to federations. The unitary forms of governments had also to contend with the dilution of their powers because of changes in political and economic fields. Whether a nation would like to adopt a federal or a unitary government would depend on several factors. The rationale for decentralization of powers and functions is very great in large countries, particularly if such countries have sizeable groups of population with dissimilar languages, cultures, religions etc. Small countries can manage well enough with a unitary form of government. Socially, culturally and politically small countries are usually very compact systems. Even in unitary states, quite a few functions are delegated to local bodies which are best suited to collecting - local taxes assigned to them through the central government. This delegation is, though, quite limited. Decentralization of powers, functions, and responsibilities has been necessitated through the rising complexity of modern life, the need to associate local people in solving their troubles and providing local services. Decentralization gives the conceptual as well as the operational underpinning of federations.

Economic Determinants

Decentralization of powers and possessions through federalism is regarded as a better solution to achieve economic take-off, optimal resource use, and removal of local economic disparities and strengthening of bargaining power in the global market. In developing countries, it is possible to enhance allocation of possessions on health, education, poverty alleviation, and social services. The objectives of equity and balanced local development may, though, not be served at least in the short run. Theoretically, with the breaking down of barriers to trade and free movement of labour and capital being allowed, the factors of production will move to regions where returns are the highest. In the USA, though, the territorial expansion of the federation intensified the conflict of economic interests flanked by the Northern and the Southern States. The South feared a situation of permanent economic inferiority to the North and hence the attempt to secede from the federation. The formation of the federation in the first place was prompted through the desire to protect their farming, trading, and the need for integrated market serving the primary interests of the rising industrial and commercial classes. The Commonwealth of Australia was a later creation through a similar procedure of aggregation and integration promoted through more or less similar thoughts. The dominance of maritime provinces has also accounted for a strong centre in Canada. In the case of India, the extreme centralization which characterized Indian administration under the British rule was intended to sub serve the British economic interests. But centralizing characteristics were slowly modified in response to the nationalist thrash about.

PRINCIPLES OF FISCAL FEDERALISM

Independence and Responsibility

The central facet of federations is the division of powers and functions flanked by the federal government and the state governments. The division of financial possessions and obligations as flanked by the two stages of governments should correspond to the division of powers and functions. Earnest efforts have to be made to ensure that each stage of government is financially self-enough and independent of each other to the maximum extent possible. Political autonomy will be meaningless unless it is supported through financial autonomy. No doubt, concerns which are of national character, or which transcend the interests of one unit, should be entrusted to the central government. Functions of a purely local character, confined to a unit in each instance, should usually be left to the Central Government. Normally, there should be no occasion for the central government to encroach upon jurisdiction of the unit governments and vice-versa. In times of national emergencies, though, the constituent units shed some of their political and financial jurisdiction in favor of the central government for achieving national objectives. Federal Constitutions usually contain specific provisions to cope with such contingencies.

Adequacy and Elasticity

Financial independence also implies that central and unit governments should have adequate financial powers to perform their exclusive functions. The correspondence flanked by revenues and functions should be understood in a dynamic sense. The sources of revenue should be elastic enough to keep pace with the growth of responsibilities in the specified spheres of activity. In order to implement a procedure of national development, the central governments were made financially strong both in conditions of powers and possessions. Customs revenue is, so, left in all federations to the central government. Same is the case with direct taxation. The sources of revenue for each stage of government should be such that the revenues generated should not remain static but should be quite elastic. The revenues should augments the needs of the governments grow. None of the governments would want to be burdened with static sources which will soon fall behind the demand that a government will have to face and meet.

Efficiency

The system of sharing of functions should conform to the necessities of efficiency and economy. "No matter how well intentioned a scheme may be or how totally it may harmonies with the abstract principles of justice, if the tax does not work administratively, it is doomed to failure". Two factors determine the effectiveness of dissimilar taxes, namely, nature of the tax and the character of administration. A land tax for instance, may be expected to be administered best through local authorities because "it is, after all, the local assessors who may be presumed to possess the mainly exact knowledge of the local circumstances upon which the value of the land depends". One of the reasons for the formation of a federation is that a government at the federal stage will be efficient for the nation as a whole: The division of sources is, so, based on the principle of relative interest and efficiency. Taxes which have an inter-state base, like customs, income and wealth tax are assigned to the federal government and those which have a local base, like sales tax and entertainment tax, are assigned to the states. Costs of collection of taxes, the feasibility of levying taxes at the nationwide stage rather than at the local stage are significant thoughts in the allocation of powers and functions.

Equity

Fiscal federation is viewed within the framework of welfare economics. Equitable sharing of wealth and income of the community are the proper concerns of a welfare state. Experts argue that the whole system of federal and state taxation and expenditure should be so framed as to impose equal burdens and confer equal benefits upon likewise placed persons irrespective of their residence. From the point of view of the nation, there is a separate advantage in taxing the richer states more and spending that revenue in poorer states since the sacrifice in extra taxation in richer states is less than the benefit that will be derived if that money were spent in poorer states. The ideal is to maximize national benefit from the state and federal expenditure. This would necessitate a reduction of welfare generating expenditure in richer states and an augmenting such expenditure in poorer states. Federal fiscal operations have an equalizing role in respect of tax burdens and benefits from public expenditure as flanked by the affluent and less fortunate states.

Distributive characteristics of income and wealth are best performed through the central government. If redistribution policy is left to the state government's local disparities may be perpetuated. Rich may leave the region where redistribution measures are more egalitarian, while the poor will move to such regions. Progressive income tax which is a significant redistribution measure necessity be uniform throughout the country. This is possible only when the tax is entrusted to the national government. It does not usually happen that the revenues appropriate to federal and state use yield exactly the sums of money required for performing their respective functions.

In mainly federations, elastic sources of revenue are in the hands of the federal government which has surplus possessions. Through several means, federal governments have further widened their sources of revenues. The resulting financial imbalance flanked by the federal and unit governments necessitates transfer of revenue to the unit governments in order to enable them to perform their constitutional functions. In fact, there has been a major extension in the functions of both the stages of governments. While the federal governments have been able to mount the requisite mobilization efforts, the state governments, mostly with inelastic sources of revenue, which cannot be stretched beyond a sure extent, have been hamstrung in their efforts to meet these expanding demands, particularly those in the social services sector. Hence the need for fiscal equalization.

Fiscal equalization has been defined as a systematic procedure of inter governmental financial transfers directed towards equalization of the budget capability or economic performance. A fiscal equalization is planned to create it possible for the governments to give a standard range and quality of services for their citizens. The fiscal capability of a government is its relative revenue raising capability on the one hand, and its relative cost of providing a standard range and quality of services, on the other. Fiscal performance is defined as a government's fiscal effort with reference to its revenue capability. In a programme of fiscal capability equalization, governments are enabled to give services on a standard scale while imposing standard burdens in the form of taxes and other charges. Fiscal capability equalization concept has meant devolution of responsibility and decentralization in the decision creation procedure. It is in fact the federalist answer to the problem of local inequality.

Fiscal performance equalization, on the other hand, involves specification of performance norms and standards to be followed through the beneficiary governments. Obviously such an exercise will involve influencing the policies and efforts of these governments with regard to resource mobilization and public spending. Fiscal performance equalization may erode the autonomy of the constituent governments and is not likely to be welcomed. One of the instruments of financial transfers is grants-in-aid. It represents a sum of money assigned through a superior to an inferior governmental authority either out of the exchequer of the former or out of sources of revenue especially designated. Grants are dissimilar from compulsory sharing or assigning of taxes, contractual payments, or loans. Grants can be classified as statutory or discretionary, open or secure-ended, general (unconditional) or specific (conditional), flat or tapering, and so on. There are many principles such as compensation, financial need, and the enforcement of a national minimum standard of social services which constitute the basis on which grants are usually made. Grants may be distributed on the basis of population, area, density of population, per capita income or a composite index combining these and other variables. Subsidies are another form of financial transfer for achieving fiscal equalization. A subsidy policy would give maximum help to the states that mainly need funds, preserve for them a larger and more independent governing role and relieve the national government of administrative burdens. Separately from grants-in-aid and subsidies, sharing of taxes and joint use of a source of revenue are also used to bring about fiscal equalization transfers. Mainly federations have recognized inter-governmental financial institutions for deliberation and cooperation flanked by the two stages of government and to smoothen the procedure of adjustment in fiscal processes.

Disagreement and Compromise

A division of powers, functions, and possessions that would satisfy federal governments and federating units in the dynamic situation that has been changing fast is not a practicable proposition any longer. The rationale for the formation of federations comes from political, cultural, social, historical, strategic, and economic thoughts. Administrative and political thoughts may often outweigh thoughts of costs and benefits. The political boundaries and the pattern of benefit sharing may not always match. When units which happen to be the better beneficiaries are large and affluent, integration may be promoted even though smaller units may nurse a grievance. In the reverse case of larger gains going to small and poor units, the large and affluent units may frustrate the integration procedure. Given the division of possessions, it may not always be possible for the states to pool together a stage of possessions that will be perceived to be adequate for satisfying the developmental objectives and aspirations of people of the states concerned. Policies and strategies for effecting credible equalizing fiscal transfers have turned out to be very controversial exercises. While the state governments have been jealously guarding their rights as provided for in the Constitution, they quite often find the federal governments' encroachment on their jurisdiction irresistible. The Constitutions usually give for the creation of inter-governmental institutions to act as the forum for the resolution of conflicts. In the ultimate analysis, though, it is the perception of the federating units as regards their long-term interests being served through the membership of the federation that helps resolve these tensions, through compromise, accommodation and perhaps some amount of coercion.

DEVELOPMENT OF FISCAL FEDERALISM IN INDIA

Mobilization, sharing, and utilization of financial possessions play a very crucial role in all systems of multi-tier government and can provide rise to hard troubles of inter-governmental relations unless handled in a spirit of mutual understanding and accommodation. In some of these systems, the national and lower tiers of government have concurrent powers in regard to sure taxes, borrowings, and outlays. This concurrency of jurisdiction often results in serious economic and administrative troubles which have to be sorted out through hard negotiations, or resort to courts.

In other bifurcated systems, there is a clear-cut division of powers of taxation and borrowings flanked by the national and lower stages of government, which through its very nature, can rarely match their possessions, and needs. It requires a mechanism for adjusting the surpluses and deficits, and reducing unavoidable vertical or horizontal imbalances of dissimilar constituent units, through resource transfers. India falls in the latter category. The Constitution allots separate legislative heads of taxation to the Union and the states. There are no taxes in the sphere of their concurrent jurisdiction. Borrowings and foreign exchange entitlements are controlled through the Union.

Growth of Fiscal Federalism: A highly centralized financial system came into being in India with the take-over of the administration through the British Crown from the East India Company in 1858. The Governor-General-in-Council retained complete control over provincial possessions as well as expenditure. The provincial governments remained entirely dependent on annual allotments through the Central Government for the maintenance of their administration. It was soon realized that decentralization was necessary for governing a country of sub-continental dimensions like India and the first step in this direction was taken in 1870. The fiscal history of the after that sixty years is very largely a procedure of gradual devolution of powers to the provinces from the Central government.

The Montague-Chelmsford Report which led to the passing of the Government of India Act, 1919, recognized the necessity of separating the possessions of the central and provincial governments to support provincial enfranchisement. The authors of the report observed: "The provinces are the domain, in which earlier steps towards the progressive realization of responsible government should be taken. Some measure of responsibility should be given at once, and our aim is to provide complete responsibility as soon as circumstances permit." Accordingly, under the devolution rules framed under the Act, customs, non-alcoholic excises including salt, general stamp duties, income tax and receipts from railways and posts and telegraphs, were assigned to the Government of India. Land revenue, irrigation charges, alcoholic excises, forest receipts, court fees, stamp duties, registration fees, and sure minor sources of revenue were allotted to the provinces.

This devolution scheme was criticized on the ground that the possessions assigned to the provinces did not have adequate growth potential and was insufficient for their rapidly rising needs, whereas the central revenues were capable of expansion, although its needs were relatively stationary. The working of the financial relations, was, so, reviewed through a number of expert committees, particularly, in early 1930's. The provisions incorporated in the Government of India Act, 1935, were based on these reviews. The Government of India Act, 1935: This Act constitutes the after that landmark in the country's financial administration. It divided the revenue sources into three categories:

- Exclusively Federal.
- Exclusively Provincial.
- Taxes levied through the Federal government but shared with the provinces or assigned to them.
- Taxes levied through the Federal Government but composed and retained through the Provinces.

The scheme also envisaged grants-in-aid from the Centre to the provinces in need of assistance as approved through the former. The Government of India Act, 1935, laid foundations for a system of elaborate but flexible financial arrangements flanked by the centre and the provinces. The long history of the development of public finance in India shows very complex factors at work. Though, one clear discernible trend is that while it is wholly possible to divide the taxation powers and allocate possessions, it is hard to establish a balance flanked by need and possessions. The several stages of development helped confirm the maxims:

- That no decentralized government can be recognized without allocating to it enough financial powers; and
- That the central government is the appropriate authority to levy a tax where uniform rate is significant and locale is not a guide to its true incidence.

MIXED ECONOMY

MIXED ECONOMY — CONCEPT AND SALIENT CHARACTERISTICS

Mixed economy implies demarcation and harmonization of the public and private sectors. In it, free functioning of the market mechanism is not permitted and the government intervenes or regulates the private sector in such a way that the two sectors become mutually re-enforcing. A mixed economy represents an achievable balance flanked by individual initiative and social goals. Planning and market mechanisms are so adjusted that each is used for realizing the objectives of the economy to which it is mainly suited. There is a commitment on the part of both the sectors to national objectives and priorities.

Ownership of sectors is used through some to classify them. A system comprising cooperative organisations would be described a cooperative commonwealth. A system of joint sector organisations gives another kind of mixed economy. A system in which both public sector and private sectors are present is the mixed economy of the conventional kind. This mixed economy could be ad-hoc or a systematic kind depending upon the extent of coverage through the public sector of core sector of the economy. The other consideration would be the extent to which the two sectors have been integrated and harmonized with the policy objectives of the economy as a whole. It would be an economy that shows concern for the welfare objectives of the weaker sections through a combination of public sharing system, poverty alleviation programmes as also the production priorities based on a market economy. It could also be an economy that emphasizes the social objectives of equity, employment, self-reliance, etc. There would be a varying degree of the mix of planning and market economy in each kind of mixed economy.

At times, it is held that every economy is a mixed economy and that the concept of mixed economy is neither precise nor worthwhile. It has, though, to be appreciated that the concepts of planned economy and market economy have definite ideological and operational profiles. The concept of mixed economy represents a middle position flanked by these two extremes. This concept is flexible and has its own means and methods of approaching economic, political, and social issues. To achieve clarity in the understanding of the concept of mixed economy, let us discuss the meaning and features of Capitalism, Socialism.

Capitalism

Capitalism has been defined as an economic system stressing individual initiative with a central role for a market economy, the profit motive, and ownership of means of production, through private individuals and corporations. Under capitalism, all means of production such as farms, factories, mines, transport are owned and controlled through private individuals and firms. Those who own these means of production are free to use them as they like in order to earn private profit. The State or government takes least part in the economic activities of the people. The government looks after only such matters as defense, foreign affairs, currency and coinage and some significant civil works such as the construction of roads and bridges because private individuals may not find it profitable to undertake such works. Adam Smith was of the opinion that interests of individuals and those of the society coincide. The government, so, has no role in economic activities. In fact, the State was inherently incapable of undertaking such activities. State undertaking would mean wastage of society’s possessions. Things should be allowed to take their own course and there was, so, no need for planning or a pre-determined framework for guiding the economic activities of the people.

Essentials of Capitalism

- The Right of Private Property: The several means of production are under the private ownership of individuals. The private individuals can hold, use or sell them as they like. Right of inheritance through the sons and daughters or other legal heirs is implicit in this right,
- Freedom of Enterprise: There is no restriction on the right of the

individual to engage in any business or enterprise for which he has the necessary means.

- Profit Motive: Profit motive is at the heart of a capitalistic system. It is profit, not any altruistic feelings; which create an entrepreneur invest in any economic activity.

- Competition: Competition exists in the middle of producers, sellers, buyers, job seekers, employers, investors etc. This is achieved through cost control, price cutting, advertisements etc.
- Consumers Sovereignty: In a free market economy, wishes and preferences of the consumers direct the economic activity. The consumer occupies a key role in the system.
- Price System: It is the price mechanism which creates the capitalist economy function automatically without there being any central direction or control on production, consumption or sharing decisions.
- Inequalities of Income: Unequal sharing of property in the middle of individuals leads to unequal sharing of incomes. There is a wide gulf flanked by the incomes of the rich and the poor.

Since there is no central planning authority to create the fundamental economic decisions and therefore to allocate productive possessions in the middle of several competing uses, the market economy uses the price mechanism which plays a vital role in the working of the economy. Any imbalances are solved and corrected automatically through the price mechanism and demand-supply interaction. There are adequate rewards for greater efficiency and hard work through higher compensation. There is also incentive to save and invest and give for higher incomes for the present and future generations. Market mechanism also enables entrepreneurs to take risks for higher profits, undertake innovations giving rise to technological progress. Capitalism is not a rigid but an involving and dynamic concept. It has successfully fought off several crises and appeared stronger.

Capitalism has an ugly face also — it divides the society into those who are vulgarly rich and indulge in ostentatious consumption, and those who are the wretched of the earth and do not have even two square meals a day. The incentive system is also vitiated through the inequalities of income which get aggravated. Consumers' sovereignty is a myth. In fact large corporation controls the market which it is supposed to serve and "even bend the consumers to its needs financial costs which capitalism imposes on the society are in the form of inflation, unemployment, and cyclical fluctuations.

Prof. Galbraith sums up the ineffectiveness of capitalism therefore: "There is much that the market can usefully encourage and accomplish — as it cannot put a man into space so it cannot bring quickly into subsistence a neel industry where there was little or no steel creation capability before. Nor can it quickly make an integrated industrial plant. Above all no one can be sure that it will do so in countries where development has lagged and where there is not only need for development but an urgent demand that it should occur promptly. To trust to the market is to take an unacceptable risk that nothing, or too little, happen.''

Socialism

"Socialism is an economic organisation of society in which the material means of production are owned through the whole community to a general economic plan, all members being entitled to benefit from the of such socialized planned production on the basis of equal rights." As against this, democratic socialism is characterized through public ownership of at least the "strategically significant material means of production" while, at the same time maintaining individual freedom of both consumption and occupation.

Features of Socialism

- It is based on social and economic planning, communal ownership of factors of production, social welfare and cooperation
- Socialist economy requires a central authority to determine the goals of society and coordinate the community's efforts to attain those goals.
- Socialist anomy is a centrally planned economy, with the central authority planning the allocation of possessions so as to attain the goals and objectives of the society.
- Equity or equitable sharing of incomes is central to socialism.
- Social welfare rather than private profit characterizes a socialist society's goals.

Democratic socialism, which is a milder form of socialism shares with capitalism subsistence of private sector, inequality of incomes, freedom of consumers and producers (subject to the demands of central planning), and subsistence of price mechanism. Socialism ensures full employment, a high rate of growth, dignity of labour and absence of use of labour, relatively equitable sharing of income and wealth & absence of Wastages associated with capitalistic system of production.

As against these merits, the system leads to loss of efficiency and enterprise, and incentives for hard work and initiative are missing. There is too much doctrinaire rigidity which pervades economic decision-creation without regard to consequences. Power is concentrated in the hands of the State which takes all decisions concerning investment, production, sharing, and consumption. This leads to bureaucratization, redtape and a very cumbersome and expensive system of administration which cannot deliver the goods. Resource allocation is arbitrary as there is no rational or workable pricing system which normally guides allocation decisions. In the absence of competition, production is inefficient and costly, and "quite often there are shortages particularly of consumer goods.

Salient Characteristics of Mixed Economy: Having described the two extremes of capitalism and socialism, it is now possible to describe a mixed economy in functional conditions. A mixed economy is characterized through:

- A balance flanked by the market economy and the planning mechanism;
- A clear demarcation of the boundaries of public sector and private sector so that the core sector and strategic sectors are invariably in the public sector;
- While profit motive influences decision-creation in the private sector, the economic viability criteria for investment decisions in the public sector is based on social cost-benefit analysis;
- The ownership of means of production as flanked by public sector, private sector, joint sector and cooperative sector is so decided that there is a balance flanked by personal and social incentives and sectional and general interests;
- There is occupational freedom and freedom of consumers' choice;
- The government intervenes to prevent undue concentration of economic power, and monopolistic and restrictive trade practices;
- The government endeavors to take care of the consumption stages and objectives of the weaker sections of the society through public sharing system, poverty alleviation programmes etc.;
- Social objectives of equity, employment, balanced local development, family welfare are emphasized;
- The doctrinaire rigidities of socialism are avoided and a pragmatic approach to decision-creation for promoting economic growth is usually adopted; and
- Mixed economy is not merely an economic concept and the rights of the individual are respected and protected subject only to the necessities of public law and order and morality.

It is incorrect to regard every country as a mixed economy just because some characteristics of capitalism or socialism are present in that system. Through this test, USA is a capitalist country and erstwhile USSR and China can be classified as socialist countries. The mere attendance of some features of a mixed economy is not enough. These are not their dominant features. Countries like Sweden, Norway, Austria, France, India, and Israel are mixed economies. A mixed economy necessity has the structural features and also professes the social democratic ideology. Countries that put greater stress on decentralized socialist market tend to approximate to or are approaching a mixed economy in the locative characteristic. Capitalist countries that put more stress on an egalitarian sharing of property and incomes (Japan, South Korea, Taiwan, and Singapore) are approaching the mixed economy ideal from the other end.

Therefore even though mixed economy is a mixed form of capitalism and socialism, it has an identity of its own. The evils of extreme economic systems of pure capitalism and pure socialism are avoided in a mixed economy. It presents a middle path.

DEVELOPMENT OF MIXED ECONOMY IN INDIA

As early as the First Five Year Plan, the Indian policy makers decided that the State necessity not only assume the responsibility of providing the infrastructure facilities and the social overheads, but should" also undertake direct promotional work. It was recognized that the government should intervene in the industrial field and accordingly the development of vital and strategic industries was earmarked to the public sector. It was also recognized that the task of economic development of the country was so large that the initiative of both the private and public sectors had to be harnessed for optimal growth. The concept of mixed economy was evolved so that both the private and public sectors could contribute to the procedure of growth. It was measured that individual enterprise and initiative would be the best catalysts of change in the sphere of agriculture, organized industries, small scale industrial units, trade and construction. With the announcement of the Industrial Policy Resolution, 1956, the concept of mixed economy was given a definite shape and policy direction. Even before that, the Industrial Policy Resolution of 1948 had sought to establish mixed economy, with both private and public sectors, rising controls in government hands for regulating all industries. The two main instruments of industrial policy were the Industries (Development and Regulation) Act of 1951 and the Companies Act of 1956. These two Acts conferred on the government, through licensing procedure, the power of regulating location, production, and expansion of major industries in the country.

Industrial Policy Resolution, 1956

The Avadi Resolution of the Indian National Congress declared the establishment of a socialistic pattern of society as the aim of economic and industrial policy of the government. The Resolution made it clear that “the State will necessarily play a vital part in starting and operating big projects through overall controls of possessions, trends, and essential balances in the economy... with strategic controls over the private sector to prevent the evils of anarchic industrial development.” Consequently, the Parliament adopted on 30th April, 1956, a new Industrial Policy Resolution, the main characteristics of which were as follows:

The industries were classified into three categories:

- Schedule A: Those industries which were to be the sole responsibility of the State. This list incorporated 17 industries — arms and ammunition, atomic energy, iron and steel, heavy machinery required for mining, heavy electrical industries, coal, mineral oils, mining, iron ore and other significant minerals (like copper, lead and zinc, etc.), aircraft, air transport, railways, ship-structure, telephone, telegraph and wireless equipment, and generation and sharing of electricity.
- Schedule B: There were about a dozen industries in the list, where the State might establish new units or existing units might be progressively nationalized. In these industries, the private sector was guaranteed plenty of opportunity to develop and expand. It incorporated the following industries: Other mining industries, aluminum and other non-ferrous metals not incorporated in Schedule A, machine tools, ferro alloys and steel tools, chemicals, antibiotics and other essential drugs, synthetic rubber, pulp, road and sea transport.
- Schedule C: Industries in this Schedule consisting of the rest of the industries, not incorporated in Schedules A and B, would be in the private sector, and would be subject to the social and economic policy of the government. The Industries (Development and Regulation) Act of 1951 and other relevant laws would apply to these industries.

In the middle of other things, the resolution emphasized that fair and non-discriminatory treatment would be given to private sector industries and their development, encouraged through developing transport facilities and through providing financial assistance. The regulation recognized that the private sector through itself could not bring about rapid industrialization of the country. It, so, provided vital and expanding scope for public sector industries. At the same time, private sector was assured of a significant place in the industrial structure of the country. The resolution also acknowledged the significant role of village, cottage, and small scale industries. The resolution accorded a prominent role to the public sector. The apprehensions of and Objectives the private sector that the public sector would develop at their cost did not turn out to be correct and private sector found ample scope for its expansion.

Industrial Policy Resolution, 1977

The new Industrial Policy of 1977 was very critical of the 1956 Resolution on the ground that “Unemployment has increased, rural-urban disparities have widened, and the rate of real investment has stagnated. The growth of industrial output has been no more than three to four per cent per annum on the average. The incidence of industrial sickness has become widespread and some of the major industries are worst affected. The pattern of industrial costs and prices has tended to be distorted and dispersal of industrial activity absent from the urban concentration has been very slow". Other points of criticism were that international giant industrial concerns had penetrated the protected Indian market and monopolistic power of the large business houses had increased. The new policy focused on the development of small scale sector, cottage and household industries and the tiny sector. It further provided for using provisions of the Monopolies and Restrictive Trade Practices Act against expansion of larger industrial houses. The public sector was to be used for providing strategic goods of vital nature and also for maintaining supplies of essential goods. In areas where foreign collaboration was not required because of the availability of indigenous technical know-how, such collaboration agreements were not be renewed. Separately from giving greater importance to village and small scale sector and at the same time instilling a sense of fear in the middle of large industrial houses, the new policy did not lead to many achievements.

Industrial Policy of 1980

Outlining the Industrial Policy of 1980, it was stated, "The Industrial Policy announcement of 1956... reflects the value system of our country and has shown conclusively the merit of constructive flexibility. In conditions of this resolution, the task of raising the pillars of economic infrastructure in the country was entrusted to the public sector for reasons of its greater reliability; for the very large investments required and the longer gestation period of the projects for economic development. The 1956 Resolution, so, forms the basis of this statement." The policy accorded priority to optimum utilization of installed capability, balanced local development, agro-based industries, export-oriented industries, and promoting "economic federalism" through equitable spreading of investment over small but rising industrial units in urban as well as rural areas.

PRIVATE AND PUBLIC SECTORS IN INDIA

Private Sector

The concept of mixed economy adopted through India implied the rejection of the thought of immediate nationalization of the private sector. It further implied a regulated private sector and the fast expanding public sector, especially in vital and heavy industries such as steel, engineering, fertilizer, power, and transport. The private sector is dominant in agriculture and allied activities in retail and mainly of the wholesale trade, cottage, rural and small scale industries, mainly of consumer goods industries like textiles, jute, cement, sugar, radio receivers, and numerous other consumer goods industries.

A number of capital goods industries such as engineering, chemicals. electronics, etc., are also in the private sector. Mainly of the professional services are in the private sector. It can be said that private sector in India including agriculture and trade, contributes almost 80 per cent to the national income whereas the public sector contributes the balance 20 per cent of the national income.

Private sector in India can be divided into two parts: (a) the organized sector and (b) the unorganized sector. The organized sector is modernized, adopts capital rigorous methods of production, and has easy access to the capital markets and banks. It uses modern means of communications, and adopts all methods to manipulate demand to suit its needs. Profit motive is the basis of all the activities of this sector. The main method of planning for this sector is to so organize the economy that the producers get enough facilities and inputs, and find it mainly profitable to so conduct their activities as to reach the plan production targets. T* more risky, and long-term gestation projects and infrastructure are left to the public sector.

In an open economy, the mainly rigorous competition could come from abroad for goods produced through the organized sector. In its desire to industrialize rapidly, India wanted to develop several industries which could not stand competition from abroad. Exchange scarcity and the need to conserve foreign exchange led to import controls. Import substitution was encouraged irrespective of the comparative advantage. Industries needing imports for their production were permitted on condition that they indigenized rapidly and costs hardly entered into consideration. Since 1960, industrial units with investment of more than a sure sum had to apply for a license for manufacturing a new article or for substantial expansion. According to Prof. D.T. Lakdawala: “There was sometimes over licensing also, but at the stage when it was found that there was excess production, issue of new licenses was stopped till demand overtook supplies. Import pre-requisites for production, import of technology, foreign capital, and collaboration, were all sparingly permitted and allowed usually after a great time lag so that production in the organized sector became highly profitable. The profits were, though, often enough not fully reflected in the books of account. Price and sharing controls only usually served to drive production and profits underground and divert production to channels less amenable to controls. The whole economy began to seethe with corruption and black market, and bureaucracy and political machinery became a big renter group.”

Unorganized private sector is spread over a vast area and it has been hard to enforce policy interventions. Secondly, due to lack of awareness, education, and training, and the absence of catalytic agencies, this sector has not been able to take full advantage of the facilities extended to them. Thirdly, organized sector often competes and also complements the unorganized sector.

Managing these interrelationships has been hard. For instance, incentives planned for handloom sector have often been siphoned off through the power loom sector. The unorganized sector often is a poor-technology, poor-remuneration sector and is often exploited in trading, credit, etc. Radical policy changes are, so, described for to create this sector viable.

Public Sector

Prior to Independence, there was practically no such thing as the public sector in India. Railways, posts and telegraphs, ordnance factories and a few assorted factories constituted the public sector. Only after the Industrial Policy Resolutions of 1948 and 1956, the government made concerted efforts to create the public sector the dominant sector in the Indian economy. It was Supposed to have control over "the commanding heights" of the economy. In the middle of the significant objectives assigned to the public sector are:

- To help in the rapid economic growth and industrialization of the economy and make the necessary infrastructure for economic development
- To earn return on investment and therefore generate possessions for development
- To promote redistribution of income and wealth
- To make employment opportunities
- To promote balanced local development
- To assist the development of small-scale and ancillary industries; and
- To promote import substitution, save and earn foreign exchange for the economy.

The following table gives us a thought of the growth of public sector enterprises in India:

Growth of Public Sector Undertakings in India

	Total Investment (Rs. in crores)	No. of enterprises
1	2	3
As on 1.4.1951	29	5
As on 1.4.61	948	47
As on 1.4.80	18,150	179
As on 1.4.91	1,01,797	236

These are the Central Government public sector enterprises. In addition, there are a large number of several State Government public enterprises like irrigation projects, State Electricity Boards, State Road Transport

Corporations, and State Financial Corporations etc. These enterprises also exclude departmental undertakings like railways. The enterprises also incorporated in the table above, large as they are — account for only about half of the gross capital formation of all public enterprises. Major contribution of the public sector has been through the development of new sophisticated industries, and giving a more mass welfare bias to the existing services. New skills were created and professional management in industry which was hitherto mainly confined to multi-nationals became widespread. Ever since the third plan, the public sector investment largely accounts for somewhat more than half the total plan investment. Separately from the normal government activities and departmental undertakings, vital and heavy industries like steel, heavy electrical and non-electrical machinery, machine tools, etc., were developed in the public sector. These were industries which would take a long time to fructify and were risky. It was felt that, through and large, private industry would not be attracted to them or would only be prepared to come on conditions which would not be acceptable to the nation. Existing units in the private sector were left untouched with the exception of banking, insurance, oil, coal, and power. Several of the sick units providing employment on a large scale were also nationalized.

Financial performance of public sector enterprises has been quite disappointing. Excluding the oil sector, which is highly profitable, the other public sector enterprises have been incurring net losses or creation only a marginal profit. Even if the oil industry is incorporated, the overall ratio of net profits after tax as a percentage of net worth are just about 4.5 per cent in 1990-91 as against 5.4 per cent in 1989-90. The sectors which have been heavily losing contain fertilizers, heavy engineering, consumer goods, urban transportation, coal, textiles, and contract and construction services.

Some of the factors which are responsible for the poor performance of the public sector are as follows:

- Administered pricing policy of the government in respect of urban transportation, coal, fertilizer industries, etc. is fully responsible for non-recovery even of costs of production. The concerned public enterprises can hardly be described inefficient, even though they are unprofitable.
- The nature of a large number of enterprises is such that they have long gestation periods and quite often there are heavy cost overruns because of the gestation periods and intervening inflation.
- Excessive manpower recruitment due to political decisions.
- Under utilization of capability.
- Excessive government controls in the matter of investment decisions, fixation of selling prices, wages and income policies, location decisions and personnel policy.

The failures of the public sector are largely rooted in the political and bureaucratic controls clamped on the enterprises. Unless genuine autonomy is given to the professional management of the public sector in all matters which are properly speaking business decisions, there is hardly any future for the public sector.

MIXED ECONOMY — RECENT TRENDS AND AN APPRAISAL

The decade of the 1980s witnessed a rapid expansion of the industrial activity in India which can be attributed mainly to the reforms undertaken in both industrial and trade policies. Further policy changes became necessary for accelerating the industrial growth in the 1990s in order to consolidate the achievements of the last decade. The new policy initiatives were announced through the government in the Statement on Industrial Policy on 24th July, 1991. The policy deregulates the economy in a substantial manner. The major objectives of the new policy package will be:

- To build on the gains already made
- Correct the distortions or weaknesses that might have crept in
- Maintain sustained growth in productivity and gainful employment
- Further encourage growth of entrepreneurship and upgrade technology in order to attain international competitiveness. All sectors of industries whether small, medium or large, belonging to the public, private or cooperative sector are to be encouraged to grow and improve on their past performance.

The provisions of the new policy are:

- Industrial licensing was abolished for all projects except in 18 industries where strategic or environmental concerns are paramount or where industries produce goods with exceptionally high import content. With this, 80 per cent of industry has been taken out of the licensing framework.
- The MRTP Act was amended to eliminate the need for prior approval through large companies for capability expansion or diversification. This will enable Indian firms to become large enough to compete effectively in the global markets.
- The requirement of phased manufacturing programmes was discontinued for all new projects.
- Areas reserved for the public sector were narrowed down, and greater participation through private sector was permitted in core and vital industries. In place of the seventeen areas earlier reserved for investment through the public sector, only eight such areas are now

reserved. These eight are mainly those involving strategic and security concerns.

- Government clearance for the location of projects was dispensed with except in the case of 23 cities with a population of more than one million.
- A National Renewal Fund has been set up to ensure that the costs of technological change and modernization industry would not be borne through the workers. It will be used to give a safety net to workers in sick don-viable enterprises, and to finance their retraining and redeployment.

Beside with a reform of industrial policies, steps were taken to facilitate the inflow of direct foreign investment. These non-debt-creating inflows will reduce reliance on fixed interest-debt and also bring in new technology, marketing expertise, and modern managerial practices. The following measures were taken in this regard:

- The limit of foreign equity holdings was raised from 40 to 51 per cent in a wide range of priority industries.
- The Foreign Investment Promotion Board has been set up to negotiate with large international firms to expedite the clearance required for projects in non-priority industries.
- Technology imports for priority industries are automatically approved for royalty payments upto sure limits.
- In order to create the economy competitive with the rest of the world, rupee was made partially convertible. This will boost our exports and also promote efficient import substitution.
- The practice of government control over capital issues, as well as over pricing of issues including fixation of premium, has been done absent with.
- Import duties were considerably reduced and rationalized in order to ensure that the high tariff walls do not perpetuate a high cost non-competitive Indian industry.

Therefore deregulation will reduce the role of government regulatory agencies. Delays in project implementation will be greatly reduced. Increased competition will lead to enhanced pressure on enterprises to reduce their costs and to improve quality. The public sector was originally conceived as holding the commanding heights of the economy and leading to technological advance. The public sector has contributed significantly to the diversification of India’s industrial structure. But its contribution in conditions of generating internal possessions for further expansion has fallen far short of expectations and its inability to do so has now become a major constraint on economic growth. It is imperative that the public sector attains the objectives originally set for it. This will require a sustained improvement in productivity and profitability. The budget support to public sector enterprises will need to be scaled down and they will be expected to maintain financial discipline in their operations.

In 1991-92, the Government undertook a limited disinvestment of a part of public sector equity to the public through the public financial institutions and mutual funds in order to raise non-inflationary finance for development. This procedure of disinvestment in the public sector enterprises is being sustained in 1992-93. It is expected that disinvestment will also bring in greater public accountability and help to make a new culture in their working which would improve their efficiency. Recognizing that sickness is a serious problem in several public sector units, the Government amended the Sick Industrial Companies Act to bring public sector undertakings also within its purview. This creates the sick public sector units subject to the same discipline as private sector units including reference to the Board of Industrial and Financial Reconstruction (BIFR) for identification of a viable restructuring package or closure as the case may be.

Indian experience has shown that the pursuit of a mixed economy framework in a developing economy is a feasible proposition. It can lead to a modest rate of growth and also substantial growth of productive capability in key sectors of the economy. Values of a social democracy have been assiduously nurtured and important results have been achieved in reducing inequalities through several poverty alleviation programmes. Recent changes in the direction of economic policy have, though, led several to doubt whether the Peruvian model of mixed economy and all that went with it, is still in place. If mixed economy is viewed as a path which avoids the rigors of both capitalism and socialism, then mixed economy has served the country well and may continue to do so in future. In spite of liberalization or deregulation, we have not moved to a state of market economy. All that has happened is that we have started questioning and even demolishing the complex regulatory frameworks administered through an overloaded bureaucracy which failed to orient itself to the task of development administration. Controls and regulatory mechanisms never shaped part of the core of development strategy, being themselves largely an inheritance of the war economy which the British Government had clamped on the country only to maximize procurement for military consumption. Removal of these controls will only create the economy more vibrant and dynamic without losing sight of the socio-economic perspectives it has set for itself.

NATURE AND SCOPE OF FINANCIAL ADMINISTRATION

FINANCIAL ADMINISTRATION: MEANING

The term Financial Administration consists of two words viz. 'Finance' and 'Administration'. The word 'administration' refers to organisation and management of communal human efforts in the pursuit of a conscious objective. The word 'Finance' refers to monetary (money) resource. Financial Administration refers to that set of activities which are related to creation accessible money to the several branches of an office, or an organisation to enable it to carrying out its objectives. Whether it is the Department of Agriculture, Railways, Road Transport Corporation, Primary Health Centre, Municipality, or Gram Panchayat, or for that matter, a family, its day-to-day activities would depend upon the availability of funds with which financial

Basics Now let us get to know some more accurate definitions of Financial Administration. According to L.D. White, "Fiscal Management comprises those operations intended to create funds accessible to officials and to ensure their lawful and efficient use." According to Jaze Gaston "Financial Administration is that part of government organisation which deals with the collection, preservation and sharing of public funds, with the coordination of public revenue and expenditure, with the management of credit operations on behalf of the State and with the general control of the financial affairs of public household."

Though this definition covers some significant characteristics of fiscal management, it fails to project a comprehensive scope of financial administration. Perhaps, after realising this limitation, G.S. Lall states that financial administration is concerned with all the characteristics of financial management of the State. Since public administration is more and more concerned with public affairs and public interest, the frontiers of financial administration are expanding and so there is a need for a comprehensive definition of financial administration. As an attempt towards this direction, the following definition is presented. "Financial Administration comprises all the activities which generate, regulate, and distribute monetary possessions needed for the sustenance and growth of the members of a political community,"

The Distinction flanked by Public Finance and Private Finance

Finance function appears to be a generic procedure which takes place in both public and private organisations. But, one should not conclude that the principles and norms which are applicable to private finance are equally applicable to public finance, for despite the challenge to the historic "separate but equal doctrine" from the integrationist movement of recent times, public organisations continue to possess sure separate features. Dissimilarities flanked by public finance and private finance are quite sharp and clear.

FINANCIAL ADMINISTRATION: IMPORTANCE

The importance of Financial Administration was not measured till after industrial revolution. The concept of minimum government as an offshoot of laissez faire doctrine, dictated observance of minimum taxation. When social life became more complex as a result of industrial revolution, the role of the government increased manifold. Further, the concept of welfare state has caused phenomenal augmenting state activity. The governments have entered into new areas which were kept out of the purview of the State. In this changed context, financial administration has gained greater significance for exploring ways and means to generate possessions to meet the ever-rising public expenditure.

The Great Depression (1929-33) had exposed the weaknesses of neutral economic stance of the governments. It enhanced the quest for stability in income and employment as well as for equality and social justice. Based on Keynesian perspective, the State has assumed an active and positive role for expanding national income and employment. It has also taken up the task of ensuring equity and equality. Fiscal policy of the government has become a Dowerful instrument in influencing the socio-economic life of the people. Defense and administrative expenditure lost its nonproductive label and assumed a new significance as a lever for stimulating income and employment stages. Financial administration was entrusted with the responsibility of formulating effective policies to achieve these new objectives of the State. It was described upon to transform financial possessions into public purposes and therefore to improve the lot of the individual through distributive justice.

With the advent of democracy, as a popular social institution, the concept of 'parliamentary control over public purse' has received universal acceptance. The principles of "no taxation without representation", i.e. "no public expenditure without parliamentary sanction" have become the guiding canons of modern political communities. There appeared an urgent need to devise a simple and systematic financial procedure in order to create financial system intelligible to the common person. Financial administration became an instrument of modem governments for creation "popular sovereignty" a social reality.

The concept of planned development has enabled public administrators to play an active and dynamic role in the formulation and implementation of development schemes and projects. The time and cost of implementing these projects have become critically significant. The accent of financial administration has shifted from one of controlling the disbursement of funds to one of management of several development projects and programmes. The rise of performance budgeting and other related budgetary innovations represent extra ordinary achievements of financial administration in meeting this challenge. From the early eighties onwards, resource crunch has become a very serious problem of modem governments. While there is a tremendous pressure on the modem governments to augment their expenditure outlays to meet the ever expanding ambitions and demands of the people the taxpayers are unable or unwilling to bear additional tax burdens. In this dilemma, a need has arisen for a careful prioritization of public expenditure. Hence a revise of financial administration and management which are a part of public administration has become significant to seek out ways for eliminating unwanted expenditure and ensuring optimization of output on a limited resource base. Zero Base budgeting is an attempt in this direction. To sum up, financial administration is playing a dominant role in modem times.

NATURE OF FINANCIAL ADMINISTRATION

There are two dissimilar views concerning the nature of financial administration. These are i) Traditional view; ii) Modern view.

Traditional View

Advocates of this view conceive financial administration as a sum total of activities undertaken in pursuit of generation, regulation, and sharing of monetary possessions needed for the sustenance and growth of public organisations. They emphasize upon that set of administrative functions in a public organisation which relate to an arrangement of flow of funds as well as to regulating mechanisms and processes which ensure proper and productive utilization of these funds. When one looks at this view from systems perspective, it represents an integral sub-system of supportive system. A financial administrator shoulders responsibility for ensuring adequate financial backing for running public organisation in the mainly efficient manner. His/her job is to plan, programme, organize, and direct all financial activities in public organisations so as to achieve efficient implementation of public policy. The participants of this system are measured as financial managers and they discharge managerial functions of financial nature. Further, this view reflects the stand taken through pure theorists of public finance like Seligman. The central thesis of pure theory of public finance is that public finance should deal with the troubles of public income, public expenditure, and public debt in an objective manner without any relation to a set of values and premises of the political party in power. Accordingly, theorists of financial administration subscribing to this view take a value-neutral stance. For instance, Jaze Gaston reflects this view when he says that financial administration is that part of government organisation which deals with the collection, preservation and sharing of public funds.

Modern view

The modern view considers financial administration as an integral part of the overall management procedure of public organisations rather than one of raising and disbursing public funds. It comprises all the activities of all persons engaged in public administration, for quite obviously approximately every public official takes decisions which are bound to have some direct or indirect consequences of financial nature. Further, it rejects the value-neutral stand of the traditional theory. It combines in itself three prominent theories of public finance, viz., the socio-political theory as expounded through Wagner, Edge worth, and Pigou, the functional theory of Keynesian perspective and activating view of modern public finance theorists. According to this view financial administration has the following roles.

Equalizing Role

Under this role financial administration seeks to demolish the inequalities of wealth. It seeks, through fiscal policies, to transfer income from the affluent to the poor.

Functional Role

Under normal circumstances the economy cannot function on its own. Under this role, financial administration seeks to ensure, through taxation, public expenditure and public debt, and proper functioning of the economy. It evolves policy instruments to maintain high economic growth and full employment.

Activating Role

Under this role financial administration involves the revise of such steps that will facilitate a smooth and rapid flow of investment and its optimal allocation to augment the volume of national income.

Stabilizing Role

Under this role, the objective of financial administration is the stabilization of price stage and inflationary trends through fiscal as well as monetary policies.

Participatory Role

According to this view, financial administration involves formulation and execution of policies for creation the state a producer of both public and private goods with the objective of maximizing social welfare of the community.

It also seeks to promote economic development through direct and indirect participation of the State. Therefore, financial administration gives a framework of choices concerning ends and means which reflect the nature and character of the State and its ideological base as well as its values. For instance, financial administration of socialist countries differs from that in democratic countries. Therefore, the essence of financial administration would differ under dissimilar socio-political systems depending upon scrupulous mode of operation of socio-economic and political forces.

SCOPE OF FINANCIAL ADMINISTRATION

Gaston Jaze's definition, quoted in that context, points out that the government organisation which deals with the following four characteristics constitutes financial administration. These contain:

- The collection, preservation and sharing of public funds.
- The coordination of public revenues and expenditure.
- The management of credit operations on behalf of the State.
- The general control of the financial affairs of the government.

In modern governments all the above characteristics are dealt with through the Finance Department and its subordinate agencies. Though the Finance Department may be measured as central financial agency of modem governments, it cannot be equated with financial administration. Its role constitutes financial management rather than financial administration. As a financial manager it deals with the systems, tools, and techniques contributing to economic decision creation in government. These processes are, in fact, the integral part of financial administration. The scope of financial administration is much wider than what these processes suggest.

According to some authorities on public administration, the term financial administration refers to the financial processes and institutions involved in legislative financial control. In their view, the scope of financial administration encompasses the preparation of estimates, appropriation of funds, expenditure control, accounting, audit, reporting, and review and so on. In a democratic context, this view may gain wider acceptance as it ensures executive responsibility to legislature. But, the experience of modem democracies has shown that the legislative involvement in the determination of the desired volume, range, and direction of programmes, the use of independent judgment relating to the financial possessions required through administrative agencies is becoming nominal day through day. It is a recognized fact that the average member of the legislature is not adequately informed to ensure effective control over executive. Therefore, the view appears to be of no important validity. Further, legislative control of financial characteristics of the government does not represent the scope of financial administration in its entirety.

Yet another view advocates a budget oriented outline for the scope of financial administration. According to them the scope of financial administration is limited to the preparation of budget, the enactment of budget and execution of budget. Though the budget is the core of financial administration, sure operations which precede budget preparation are equally significant. There is a pertinent need to contain planning procedure as an integral part of financial administration. In the ultimate analysis, there is a need to adopt an integrated approach so that all the above views are incorporated into the scope of public administration. As an outcome of such an approach, the following characteristics emerge as the core areas of financial administration.

- Financial planning
- Budgeting
- Resource mobilization
- Investment decisions
- Expenditure control
- Accounting, Reporting and Auditing

Financial Planning

In a restrictive sense one may consider budgeting as planning since its vital concern is to facilitate the formulation and adoption of policies and programmes with a view to achieving the goals of government. But planning, in a broad sense, comprises the concerns in conditions of whole range of government policy and it demands a time frame and a perception of the inter relationships in the middle of policies. It looks at a policy in the framework of long-term economic consequences. There is a need to coordinate planning and budgeting. The concept of Planning-Programming- Budgeting System (PPBS) represents an attempt in this direction. Financial Administration, under this stage, should consider the sources and forms of finance, forecasting expenditure needs, desirable fund flow patterns and so on.

Budgeting

This area is the core of financial administration. It comprises examination and formulation of such significant characteristics as fiscal policy, equity, and social justice. It also deals with principles and practices associated with refinement of budgetary system and its operative processes.

Resource Mobilization

Imposition of taxes, collection of rates and taxes etc. are associated with resource mobilization effort. Due to the ever rising commitments of government, budgetary deficits have become regular characteristic of government finance. In this context deficit financing assumes greater importance. But deficit financing, if used in an unrestrained manner, may prove to be a dangerous problem for a nation's economy for it can cause galloping inflation. Another challenge faced through administration is tax evasion and growth of parallel economy. Finally public debt constitutes yet another element of state possessions. The proceeds of debt mobilization effort should be used only for capital financing. Therefore, modern financial administrator has to be fully conversant with all the dimensions of resource mobilization efforts.

Investment Decisions

Financial and socio-economic appraisal of capital expenditure constitutes what has come to be recognized as project appraisal. Since massive investments have been made in the public sector a thorough knowledge of the concepts, techniques, and methodology of project appraisal is indispensable for a financial administrator.

Expenditure control

Finances of the modem governments are becoming quite inelastic. Approximately every government is suffering from resource crunch. Further, the society cannot be taxed beyond a sure point without doing a great damage to the economy as a whole. Therefore, there is an imperative need for careful utilization of possessions. Executive control is a procedure aimed at achieving this ideal. Legislative control is aimed at the protection of the individual tax payer's interest as well as public interest. There is also the need to ensure the accountability of the executive to the legislature.

Accounting, Reporting, and Auditing

These characteristics are intended to aid both the executive control and legislative control. In India, the Comptroller and Auditor General (C & AG) and the Indian Audit and Accounts Department over which the C & AG presides ensure that the accounting and audit functions are performed in accordance with the provisions of the Constitution.

COMPONENTS OF FINANCIAL ADMINISTRATION

Theorists of public finance have recognized three elements of public finance. They are:

- Public Revenue
- Public Expenditure
- Public Debt

Since financial administration concerns itself with public finance and deals with the principles and practices pertinent to the proper and efficient administration of the state finances, the thinkers of financial administration have incorporated the administrative characteristics in the scope of financial administration. Some other thinkers, taking clue from Luther Gulick, have tried to project POSDCORCs view wherein:

- P— Stands for Financial Planning
- O— Stands for Financial Organisation such as Finance Ministry
- S— Stands for financial Personnel
- D— Stands for Direction such as Financial advise
- CO — Stands for Coordination of Income and Expenditure R — Stands for Financial Reporting such as accounting C — Stands for control which comprises executive control, audit control and legislative control.

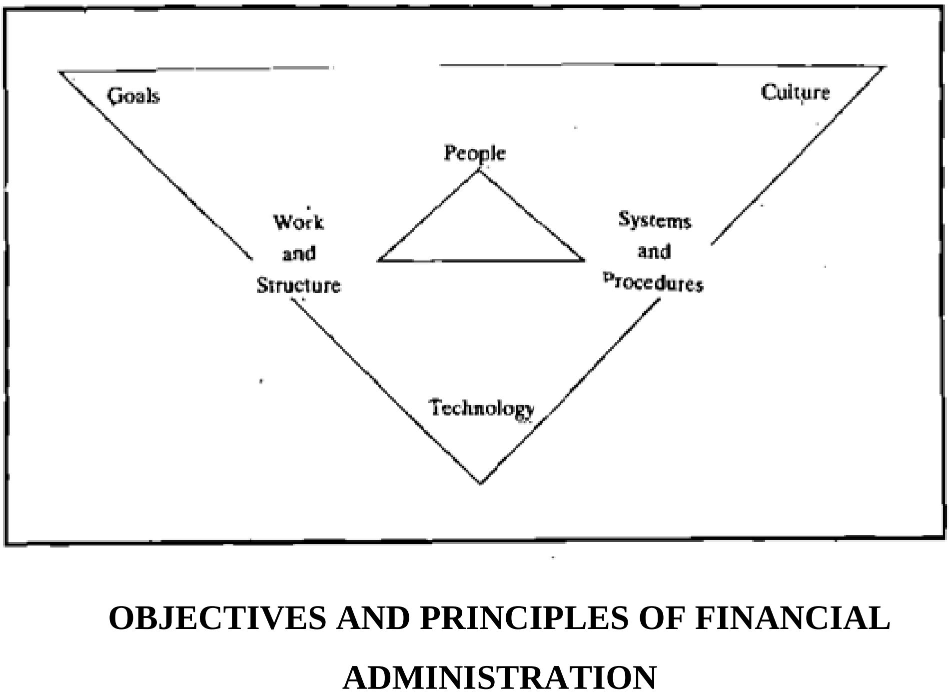
The above exposition does not reveal the exact picture related to the elements of financial administration. An organizational system consists of the following vital elements:

- The People
- Work and structure
- Systems and procedure

People represent human possessions of the organisation. Work and structure represent efforts and processes concerning definition of tasks and roles, and organisation of reporting relationships. Systems and procedures represent framework to facilitate interactions flanked by the people and the work.

Human element consists of participants whose involvement is determined through contribution-inducement equilibrium. This consideration implies that people, for instance, wish to contribute their money (tax etc.) and support the government as long as there is a feeling on their part that they are suitably rewarded for their sacrifice and support. No public organisation can easily overlook this consideration. Work and structure refer to the organisation processes viz. divisional processes and integration processes through means of which organisation subdivisions are created with a provision for mutual interaction. Systems and procedures are the devices which link the people to the work and structure. These three components interact with each other to produce organizational outcomes.

No discussion on administration's components would be complete unless there is a reference to the environment which affects content, character, and capabilities of the components. Financial administration is enveloped through two environments. Every one is aware of supra system recognized as socio-economic and political environment in which the financial administration operates. There is an intermediary sub-system' comprising the goals pursued through financial administration, the norms, values, beliefs and behaviour as reflected in the culture of financial administration and the nature of technology employed through financial administration. The overall picture may be presented in the form of the following illustration:



OBJECTIVES AND PRINCIPLES OF FINANCIAL ADMINISTRATION

PRINCIPLES OF FINANCIAL ADMINISTRATION

In the beginning of the 20th Century thinkers like Adams measured financial administration as a component of Science of Finance. Some of the modern authors also hold similar views. According to these authors financial administration is a fiscal science. Since "fisc" is a part of the government machinery, financial administration reflects the nature, character, and scope of the State. Moreover, financial administration is concerned with actual troubles and hence, its ends and means depend upon the kind of the economy. Due to this cultural specificity, it is very hard to accept the claims that the financial administration is a science and as a consequence of this realization one has to know that the norms of financial administration for a country at any given time depend upon the objectives of national policy and prevailing socio-economic and political realities. Because of these limitations, some of the economists like Hicks treated public finance as an art.

Under this situation it becomes very hard to think in conditions of principles of financial administration. Though, if one studies the development of financial administration and its administrative patterns through cross-national and cross-cultural contexts, it is possible to infer some broad guidelines in the form of pragmatic concepts. Accordingly, the following may be listed as some of the significant principles in this regard.

- The principle of primacy of public interest, public choice and public policy
- The principle of political direction and control
- The principle of correspondence
- The principle of unity of organisation and management
- The principle of stability and balance
- The principle of simplicity and flexibility
- The principle of conduct, discipline and regularity
- The principle of public trust and accountability.

Let us discuss these principles in detail as follows.

The principle of primacy of public interest, public choice, and public policy

Professor Adams, in his "Science of Finance", stated that the Science of Finance treats of the wants of the State and the means of their supply and hence the fiscal policy should not impair the patrimony of the State. He measured this dictum as a significant axiom of fiscal policy and administration. The patrimony, according to him, consists in a flourishing private industry. But this concept of the State's patrimony has undergone a drastic change and at present it is public interest which can be measured as locus as well as focus of the State activity. Public interest can be interpreted in several ways such as the common good, the general welfare, and the overall quality of life of modern and subsequent generations, the communal realization of social values, rights, and privileges. For, fiscal policy and administration, it is imperative to concentrate on those kinds of activities which create a definite and justifiable contribution to the accomplishment of public interest and public satisfaction as expressed in public policies. It is quite essential to realize that fiscal policy is expected to sub serve the broad aims as spelt out in public policies. One should be clear about the meaning of public choice. Some erroneously try to identify the public choice with the choice of the greatest number or the aggregation of individual and group interests. Public choice is a choice which encompasses common life and is shared through all.

The principle of political direction and control

Every society possesses what may be described politico-legal framework for conditioning all forms of human activity, both public and private. This structure is found in vital laws of the land and in prevailing customs, conventions, and traditions through which political ideals and ideas find their way. Financial administration, as a subsystem of public administration, should conform to these political ideas and ideals as expressed through the constitutional procedure of the society. Further, it should adjust itself to the political structure of a scrupulous society to which it is attached. In modem times, democratic ideas and ideals have replaced all the previous structures and ideals. So, the system of financial administration is to be organized and operated in a manner so as to secure compliance with the will of legislature as expressed through the Appropriation Act, the Finance Act and other policy devices, both public and fiscal. In order to ensure its control over financial administration of the executive government, the legislature takes an account of financial functions through an independent audit organisation.

The Principle of Correspondence

This principle implies that there should be a causal relationship flanked by the objectives of financial administration and the functions, the human and material possessions necessary to accomplish such objectives. In other words, the kind of functions, the personnel required to handle them and the physical facilities necessary for the purpose should have a rational mutual interrelationship. The essence of this principle is that the objectives and the functions should give the basis for staffing and equipping of the financial organisation.

The Principle of Unity of Organisation and Management

P.J.J. Pinto, an Indian authority on financial administration, gave prominence to this principle. He links centralization to efficiency. While elaborating he clarified that it should not be taken to mean centralization of every minute detail at the top of hierarchy. According to him it does mean that the work of the dissimilar financial and non-financial agencies is coordinated and highly evaluated through the top officials of the government.

This dictum does not mean centralized decision creation and decentralized implementation. Experiences of developing countries have exposed the inadequacy of centralized decision creation. Now, the need of the hour became centralized direction and decentralized decision creation and decision implementation. The concept of administrative financial control has given way to the concept of management of results. Under this changed context, this principle should be taken to mean centralized guidance for facilitating decentralized decision creation with a view to securing optimum production as well as optimum utility. The concept of national planning is a good instance.

The principle of stability and balance

It is a recognized fact that the financial administration is characterized through technical expertise and hence cannot be handled through unskilled and non-trained personnel. This character poses serious troubles when there is a loss of specific trained personnel. So, this principle calls upon financial organisations to develop capability to withstand losses of specific trained personnel without serious consequences to effectiveness and efficiency. For this purpose, there is need for effective manpower planning together with a good programme for human resource development.

The principle of simplicity and flexibility

In a democratic era electorate functions as the fountain of all authority. All other democratic institutions, including parliament, derive their authority from electorate. So, it is very essential that the financial system and its procedures should be simplified in such a manner so as to become intelligible to the layman. According to P.J.J. Pinto, if this principle is implemented properly, it cans economies the costs. The principle of flexibility implies that the financial organisation should develop capability to adjust itself to fluctuations on work flows, human compositions, and physical facilities.

The principle of conduct, discipline, and regularity

The principle of conduct implies that the officials of public financial organisations should act ethically and set high ethical standards and styles to the people. Income tax officials, for instance, could be very effective in preventing tax evasion through setting ethical examples themselves. The principle of discipline implies that the objectives, rules and regulations, the policies, procedures and programmes necessity be honored through each participant of public financial organisation. No organisation can function effectively without firm financial discipline. The practicing administrators are prone to use imposed discipline which may not yield desirable outcomes. What is needed is voluntary or self-discipline.

The principle of regularity implies that no public organisation, including financial organisation, can afford to function at intervals. We should bear it in mind that the administrative task is a continuous procedure.

The principle of Public Trust and Accountability

Financial administration collects and disburses public funds as a public trust. But, it is quite vulnerable and can lead to misuse of these funds for personal interest. Financial administration has so to be held publicly answerable for proper use of funds at many stages such as political, legal, administrative, organizational, professional, moral, and inspirational. Here accountability implies answerability for one’s responsibility and for trust reposed in an official.

FINANCIAL ADMINISTRATION IN INDIA

Now we shall discuss the system of financial administration in India from historical perspective and its emerging trends.

Historical Perspective

Financial administration, as a practice, is not new to India. In Ramayana, there is a reference concerning balanced budgeting. Financial administration reached an advanced stage of development as early as 4th century B.C. Kautilya’s Arthasastra was a treatise on financial administration. It contained many sound principles of public finance and financial administration. Mauryan administration accepted out its fiscal functions in conventionality with these principles. Land revenue was a principal source of revenue and it was based on land yields. Taxes were also imposed on commodities such as gold, cattle, etc. Income from public works constituted a major source of non-tax revenue. Public borrowing and deficit financing were unknown. There was a well organized financial structure which incorporated offices of the Collector General, the Treasurer General, and the Accountant General. Fiscal decisions were influenced through royal whims and fancies and there was no sound system of financial accountability. Gupta's period had more or less a similar system of financial administration. Mughal period saw an elaborate and systematic financial system. Land revenue sustained to stay as the main source of revenue. It was being levied after a systemic procedure recognized as survey and settlement. The vital structure of revenue administration was intended in India through Shershah.

Raja Todarmal, a noble of Akbar's Durbar, systematised it and codified the principles of revenue administration in the form of a manual which was adapted through Britishers at a later date. They have created intermediate relationships on land matters. Jazya, Income Tax, capitation tax etc., constituted other direct taxes. Indirect taxes comprised customs, sales tax, octroi and excise duties. There was a network of government and non-government treasuries for collection, custody and disbursement of public funds.

Though the aforesaid heritage has left their indelible foot prints on fiscal history of India, a beginning for the modem financial system was made throughout British rule. Throughout this period, financial administration has passed through many separate stages of development. One can broadly divide financial administrative history of India into following four separate stages:

- Period I (1765-1858) ... Creation of structure and concretization thereof. _
- Period II (1860-1919) ... Development of Systems and Procedures.
- Period III (1919-1947) ... Democratization and Decentralization
- Period IV (1950-till date) ... Development orientation.

Period I: Creation of structure and concretization

Acquisition of Diwani Rights in 1765 marked the commencement of financial administration of British India. All the powers were vested in the East India Company and these were exercised through it through the Board of Control. Revenues from India were treated as commercial earnings of the East India Company. The British government could only influence the Company administration through indirect methods as provided for in several Regulating Acts. The superintendence and control of public finances vested separately in each of the Presidency headed through a Governor. The Governor-General of India could not utilize these funds unless he got a specific permission from the Board of Control. Though, he could use these funds throughout war period. In

1833, the British Parliament swung into action when there was a gross mismanagement of company administration. Under the Government of India Act 1833, the East India Company lost its authority to govern India on its own.

It held the property as trust for the Crown. The Act vested the superintending and controlling authority in the Governor-General of India. The Governors lost their authority as they could not make any new office, or grant any salary or allowance or gratuity without sanction from the Governor-General. The Finance Secretary to the Government of India was charged with the responsibility of conducting and co-coordinating financial operations such as preparation of estimates, provisions of ways and means, negotiation of loans, and supervision of accounts. He was to review all proposals for new expenditure.

The Accountant General of Bengal became Accountant General of India and he was entrusted with the responsibility to submit financial returns and accounts to the Finance Secretary. There was no authority to conduct audit as it remained with the provinces. With a view to strengthening the hands of the Finance Secretary through a combination of finance and accounts, he was made Accountant General of India in 1854. This system could not last long. In 1857, under the reforms initiated through Lord Canning, the Finance Secretary was given exclusive charge of finance. The Accountant General of India who took over accounts function from the Finance Secretary was invested with the responsibility for audit.

The procedure of consolidation of financial administration had begun in 1858. The Act of 1858 brought the formal authority of the East India Company to an end. The British Government assumed supervision and control over Indian financial system. The Act had provided for the Secretary of State for India, with the Council of India to assist him, as a Minister of State in the British cabinet, responsible for Indian financial and administrative affairs. No appropriations could be made from Indian finance without his prior approval. The Governor-General enjoyed delegated financial authority. The Secretary of State for India controlled Indian finances through many ways such as approval of budget, control of expenditure through a system of rules and regulations as expressed in codes and executive orders. He was assisted through a finance committee and the finance secretary who headed the Finance Department of the India office as an adviser. The Council of India, which was required to discharge a watch-dog role, failed to play its role as it had no means to control an ‘absolutist’ secretary of state. The parliamentary control over the Secretary of State for India was quite ineffective for several reasons such as lack of time, lack of interest, and growths in the national movement in India. The Secretary of State for India appeared as the ‘de facto’ authority. But he was not in a position to exercise effective control due to such limitations like ignorance of local circumstances, absence of effective communication system, geographical factors (aloofness) etc. He had no option except to delegate important financial authority to the Governor-General of India who appeared as actual master of financial activities of India. In India there was no authority to control him as the legislative council had no authority to look at financial matters. The era of excessive dependence of provinces on the centre which began from 1833 sustained under the Government of India Act 1858. The Accountant General sustained to exist in his inferior status as compared to the Governor-General of India.

The Finance Member was to preside over and direct the Finance Department. He performed a number of duties with regard to India's finances. He prepared annual financial statement, watched the progress of income and expenditure so as to ensure soundness of the financial system supervised and administered monetary system and supervised and controlled Provincial Finance Departments. The Finance Department under the leadership of the Finance Secretary had to ensure that the restrictions imposed through the Secretary of State for India were adhered to and that the rules and regulations were observed. It had dual power, namely pre-budget scrutiny and expenditure sanction.

Period II: Development of systems and procedures

The Governor-general found it impossible to handle financial troubles single-handedly. In 1859, in response to his request, the post of the Finance Member was created in the Executive Council to assist him. Wilson was the First Finance Member. Till then there was no system of budgeting as the law did not give for it. Wilson presented the first budget to the legislative council on 18-2-1860, although the law did not require him to do so. Though the council did not discuss his budget, his presentation created great interest in finance. It set a precedent through which whenever there was a financial purpose the budget was presented in the council and discussed in greater detail. From 1861-62 annual budget system was recognized. The Councils Act of 1892 authorized the Governor-General of India-in-Council to frame rules authorizing discussion of the budget in the legislative council with no right to alter the budget proposals. But the members were not free to move any resolutions. There was a constant agitation both inside and outside the house, to secure popular control over public purse. Congress in its annual sessions of 1895 and 1896, passed resolutions for full-fledged budget system. The Act of 1909 provided for an elaborate discussion of annual budget with a provision for passage of resolutions on budget estimates. Though the Act of 1909 is an important step towards budgetary development, it acquiesced limited benefits as these resolutions were not binding on the government. The Act of 1919 introduced modem system of legislative approval of the budget. The legislature was empowered to assent or refuse its assent or reduce the amount referred to therein. But the system suffered from two limitations. Firstly", the government could overrule popular opinion. Secondly, the list of non-notable items accounted for more than half of the budget. The Act of 1935 made no extra ordinary change in this system.

In 1860, the Accountant General was designated as Auditor General of India and was responsible for discharge of many functions such as accounting, supervision of public department operations etc. The Act of 1919 gave statutory status to him. He was independent of the government so as to enable him to perform his watch-dog functions effectively.

Period III: Democratization and decentralization

Upto 1909 the Central Legislature was loaded with powerful bureaucracy. The Minto-Morley Reforms of 1909 contemplated limited induction of elected elements in the Central Legislature. But under the Act of 1919, the non-officials shaped the majority in the provincial councils and the Central Legislature was enlarged and made more popularly representative. This Act provided for maximum popular representation to provincial governments. It also envisaged dyarchy in the provincial governments in which the procedure of provincial autonomy was completed in 1937 when popular governments were shaped under the Government of India Act of 1935. The dyarchy was introduced in the Centre under the Act of 1935 according to which about 20 per cent of the expenditure was brought under popularly elected members of the Viceroy’s Executive Council. But special powers enjoyed through the Governor- general had frustrated popular participation.

There was no Central Government before 1833. The era of dependence of the provinces on the Centre began in 1833. The dependence was so much that no Governor could make a permanent post carrying salary of more than Rs. 10/- per month. The same system sustained under the Act of 1858. The vital premise was that the Empire necessity be treated as a whole, not a collection of separate States.' Though provincial authority was augmented through several contracts and settlements made in 1870, 1877,1882,1897,1904 and 1911, this vital premise remained unaltered till 1919. The Act of 1919 was a landmark in fiscal federalism. It brought about a statutory sharing of powers and responsibilities flanked by the Centre and the provinces. Provinces were not required to submit their budgets on transferred subjects. But, this Act envisaged important powers for the Governor-General to supervise and control the Governors. For instance, he could send directions in the form of messages to the Governor: The vital characteristics and structures of full-fledged and Objectives federalism was introduced in 1935 which continues to exist even today.

Period IV: Development orientation

Independence brought vital changes in the political context of financial administration. There was a formal acceptance of the principle of executive responsibility to the legislature. The budgetary and other systems and procedures were tuned to sub serve this principle and its implementation. Legislative Committees began to take active interest in the form, content, legality and regularity of public spending. The Comptroller and Auditor General became a constitutional authority with a responsibility to aid legislative control. The financial administration slowly shifted its focus from stability to welfare, development and equity. Planning and Budgeting got united in the form of Performance Budgeting in 1974 which gave result orientation to financial processes. The system of financial control has been basically restructured so as to create it an instrument of plan implementation. Consequently, important powers were delegated to spending departments through several delegation schemes such as the schemes of 1955, 1958, 1962, 1968 and 1975. The responsibility for financial control has been fixed firmly on spending departments. This was sought through two means. First one was the scheme of Integrated Financial Advice and the second was the separation of audit and accounts.

In order to meet the rising financial needs of development expenditure, budget became an instrument of resource mobilization. Consequently, many steps were taken to rationalize tax structure. Kaldor's tax proposals, Wanchoo Committee Report, Jha Committee Report stand out as instances of these steps. Deficit finance became a regular characteristic as the government had to cope with tremendous pressure of quickening the pace of development. Nationalisation of banking system was measured as an instrument to channel national funds towards development activities. Public sector assumed important importance in advancing the goals of development and equity. There were sure undesirable consequences. Galloping inflation, sinking balance of payments position, rising negative returns from public sector, shrinking public savings and resource base etc., have had a cumulative impact on financial administration in such a way that the government had to take steps to set right these tendencies.

To sum up, throughout period I the vital thrust had been on the formulation of financial organisation with the aim of creating centers of control and direction in the form of Secretary of State and Governor-General. Period II was characterized through efforts to evolve a sound budgetary system and its practice. Period III saw responses to freedom movement and as a result of which gradual induction of popular element was attempted. It also saw decentralization of authority and creation of federal structures. The last stage is characterized through orientation towards people and their well-being and development.

New Emerging Trends

Regulation and control of fiscal deficit

Development efforts in India are characterized through an order of investment much higher than the accessible domestic possessions. The gap should have been met from favorable balance of payments and external remittances. But Indian policy framers met this gap through creation of credit on excessive dosage of money supply. Deficit financing was used as an alternative to resource mobilization including taxation. The annual average rate of deficit financing began to rise year after year. It was far in excess of conceivable safety limit which is said to be set through the rate of growth of supplies of consumer goods, degree of monetization of economy-, and the extent of control over production and sharing. As an outcome of such indiscriminate deficit financing, a high rate of inflation has characterized the economy since the middle of sixties. It has also caused balance of payments troubles. This situation culminated into an economic crisis in July, 1991. The government had to take a number of measures for overcoming this crisis. The main objective was to control fiscal deficit and bring it down to 5 per cent of G.D.P. (national income) through 1992-93.

Cutback on non-development expenditure

A substantial portion of Indian possessions are frittered absent in non-development expenditure which is an unproductive channel. There has been tremendous augmenting non-development expenditure. An important amount of this expenditure is associated with extravagance, inefficiency and in fructuous public policies and activities. Massive outlay on defense and law and order has also contributed towards this trend. Public policy has focused its attention on lowering of expenditure. The bulk of the savings are sought from the cuts on subsidies, defense spending, resource transfers to public enterprises, current and capital spending. The government declared that throughout the remaining part of the financial year, there will be no net additions to expenditure through supplementary appropriations unless such proposals are supported through matching savings elsewhere.

Development of zero base perspective

Budgetary decisions in India have been characterized through Increment list approach. Though no wholesale installation of zero base budgeting was attempted, expenditure policy that evolved throughout the last five years took into account the vital premises of this new budgetary concept. No area of government spending was sought to be exempted from scrutiny.

Application of contingency approach

Contingency approach emphasizes analysis and understanding of all subsystems of public organisation along with the supra-system of environment so that public police; and administrative actions can be adapted and adjusted to the demands of specific situations and contexts. It enables the public administrator to evolve a practical answer to a complex problem. The approach of the government to meet recent economic crisis has reflected the vital elements of this latest theory. For instance, though the government has political authority and vital inclination towards deficit financing, it is forced to take decisions to the contrary. It was because of the circumstances of the situation. Likewise, the concepts of self-sufficiency and social equity are no longer the dominant thoughts of the Government as is apparent from the open door policy towards foreign participation with a special emphasis on Non-Resident Indians and a host of other public policy decisions which are being taken in pursuit of orientation of the economy to market mechanism.

De-emphasized public sector

In India the rationale for public enterprise had been based on the premise that the state ownership was desirable for the attainment of national objectives. This value consideration resulted in large Scale at nationalization. Recurring losses of a large number of public enterprises, need for possessions for bringing down the fiscal deficit, global trends towards privatization of public enterprises have all changed the government's policy towards the public sector. New industrial policy of the government has brought an end to this thinking. For instance, the Eighth Plan's outlay on public sector is to the tune of 43.2 per cent as against 54 per cent on the Seventh Plan. The Government is against providing additional budgetary support to public sector. In fact, the trend is towards removal of the distinction flanked by public sector and private sector and towards the emergence of "national sector" in which public sector and private sector merge with each other. The government's move to solicit equity participation of private sector in public sector enterprises is an important policy measure indicating the new approach.

Non-bureaucratic delivery of public goods and services

Following public choice theorists, the government is thinking in conditions of providing public goods and services competitively to avoid the pitfalls of public monopoly. The government, for instance, is seriously thinking in conditions of involving private sector in power generation and sharing, electronic media and telecommunications, roads etc.

Focus on decentralized responsibility for financing development plans

Union Government has had the responsibility for plan formulation as well as plan financing. The state governments could execute centrally sponsored schemes rather than the schemes supported through their budgetary provisions. This tendency on the part of the State led to a lack of concern for resource mobilization. This syndrome is apparent from rising emphasis of the state governments on populist measures. As a back-up to economic reforms the Union Government has veered round to the concept of "indicative planning". This changed outlook pervades the formulation of the Eighth Five Year Plan. The Union Government, is now promoting cooperative federalism and is so, seeking an active role for the state government in resource mobilization.

Towards deregulation and liberalization

Union Government in an effort to give full freedom to market mechanism so as to maximize productive potential of enterprising business people is moving towards a free market economy. Industrial policy has been suitably amended to accommodate genuine necessities of private sector and foreign direct investment.

There is a rising feeling that the inequalities of income and wealth may get accentuated and that the poor and weaker sections of society may be left to tend for themselves. This unfortunate trend can be largely redressed through increased expenditure on social services and rural development programmes. There is already proof that the government is taking policy initiatives like strengthening of public sharing system and other means to ensure that growth is not achieved at the cost of equity.

To sum up, these new trends are planned to liberate market forces from bureaucratic control. These trends were found to be quite in conventionality with the necessities of underdeveloped countries. In fact, some countries have registered astonishing breakthrough with similar policy packages. So, the government did not face any major resistance against its approach. A major failure though expected, has been the inability of the government to contain price rise. The government is seeking a period of two to three years to show concrete outcomes. One has to wait and see if the new policies can pull the country out of economic stagnation and the price paid for such is also affordable.

REVIEW QUESTIONS

- Describe the structure, functions and status of the Finance Commission and the role played through it in respect of Centre-State financial relations.
- What do you understand through the term federation? How are federations shaped?
- Describe the respective roles of private sector and the public sector in the Indian economy.
- Explain the meaning of Financial Administration.
- Why has the revise of financial administration become significant in recent times?
- What are the objectives which are reflected in the fiscal policies of the developing countries?
- What are the fundamental concerns -of financial administration which transcend politico-economic compulsions?

CHAPTER 2

BUDGETING AND BUDGETARY SYSTEM-I

STRUCTURE

- Learning objectives
- Indian budgetary system
- Government budgeting: principles and functions
- Fiscal policy, equity and social justice
- Review questions

LEARNING OBJECTIVES

After learning this Unit you should be able to:

- Explain the development of budgeting system in India.
- State the meaning and components of budget.
- Explain the meaning and scope of fiscal policy.
- Indicate the significant objectives of fiscal policy.

INDIAN BUDGETARY SYSTEM

DEVELOPMENT OF BUDGETING SYSTEM IN INDIA

Kautilya's Arthashastra, which describes the administration throughout Mauryan period creates reference to an excellent budget system with very detailed, minute rules about the maintenance, preparation, submission and scrutiny of accounts. Every year, the Finance Minister made a note of the opening balance in the Treasury, of all current expenditure, including capital projects in hand (Karaniya) as well as those which had been completed (Siddham). Beside with this there was a detailed statement of receipts from all sources; and also a statement of the closing balance anticipated at the end of the year. Full and precise accounts were kept of all receipts and outgoings, on Revenue and Capital accounts; plans were also prepared and incorporated in the budget of all proposed new and profitable expenditure for investment.

The accounts incorporated estimates for the coming year, and the actual results of the year just ended. The whole Cabinet sat in a conclave, so to say, to scrutinise them and to pronounce upon their accuracy, fullness and satisfactory nature in all respects. And their business was not only to verify the actual figures, to tally expenditure with outlay through vouchers and receipts, they also had to see that full value was received for every pie spent; that the clerks, officers and departmental heads that done their duty honestly and efficiently. A system of fines or rewards helped to make the system very effective. The rewards as well as punishments fell as much upon clerks as upon the superior officers, inspectors or even the Auditor-General.

The rulers of the Delhi Sultanate and the Mughal empire also sustained a financial system not very dissimilar from the Mauryan system. With the advent of the British rule, the Indian financial administration came effectively under the control of the East India Company. Till 1833, the presidencies of Bengal, Bombay and Madras were quite independent in finance and there was hardly any centralized financial system. This position changed with the Charter Act of 1833 which vested the superintendence, direction and control of all the revenues in the Governor General of India-in-Council.

The main activity of the East India Company being territorial expansion, expenditure on costly wars mounted. Vast sums were remitted to England on account of interest payable on Indian debt, interest on investment on Railways, civil and military charges supposed to have been incurred in England on behalf of India, including the expenses on the maintenance of the Office of East India Company in India. That the Governors of the three presidencies hardly had any powers can be seen from the fact that no governor could make a permanent post carrying a princely salary of more than Rs. ten per month.

Following the first war of Independence, in 1857, there was chaos in financial administration. With the takeover of the Indian administration through the Crown, the financial system came to be fashioned on the lines of the system prevailing in England. Imperial objectives dictated a highly centralized system of financial and administrative control. The first budget was formally introduced in India in 1860 through Sir James Wilson, the then Finance Member of the Governor-General-in-Council. There was at that time no elected legislature in India. The budget was also not presented to the British Parliament. The budget, though, made the Viceroy/Governor-General-in-Council accountable to the Secretary-of- State-in-Council in London who, as a member of the British Cabinet, looked after Indian affairs. The Secretary of State became the fountainhead of all authority. He delegated powers to the Governor-General of India. The powers had to be exercised within the ambit of rules and regulations which had to be strictly followed.

According to Thavaraj, the vital characteristics of the financial system in India throughout the period 1858-1935 were:

- The Secretary-of-State-in-Council was the chief regulator of the financial system;
- Governor-General-in-Council exercised delegated financial authority;
- Finance Department was the custodian of Indian finances and
- Controller General had combined responsibility for Indian Audit and Accounts. The Secretary of State controlled Indian finances through:
    - Acceptance of the Indian budget;
    - Regulation and control of expenditure through voluminous rules, regulations and codes; and
    - Through numerous executive orders.

The budgetary system, more or less, retained these characteristics in spite of the reforms introduced through Lord Mayo in 1870, Lord Lytton in 1877, Lord Rippon's Quinquennial Settlements of 1882 and Lord Curzon's Reforms, 1904. The scene, though, changed significantly following Montague-Chelmsford Reforms of 1919. From 1921 onwards, the Central Legislative Assembly, with a non-official majority, was for the first time given the right to discuss and pass the annual budget of the Government of India in respect of 'non-reserved' subjects, as also to pass the Finance Bill embodying taxation proposals. The Governor-General was, though, empowered to "certify" the financial proposals in the event of their rejection through the legislature.

Before these reforms were introduced, the provincial governments had to seek the approval of the Central Government for every rupee spent. The Montague- Chelmsford Reforms for the first time introduced realistic provincial autonomy. Central and provincial heads of revenue were clearly demarcated. Consequently, the importance of the supervisory role of Finance Member over the provincial finance departments declined considerably and vanished altogether after 1935. The Secretary of State, though, did not suffer any diminution in his supreme authority after the 1919 reforms. Nothing of significance could happen without his knowledge. But he intervened only when the imperial interests were in jeopardy.

The Government of India Act, 1935, delivered a body blow to his powers. Except for the control over the services, the Secretary of State gave up direct exercise of mainly of his powers. The Governor General and the Governors exercised special powers and prerogatives over what were described reserved subjects which together with charged items were outside the purview of legislative financial control. They could also restore a demand rejected or reduced through the legislatures. Again, no expenditure could be incurred even if it was duly authorized through the legislature unless it was incorporated in a schedule of expenditure authenticated through the Governor-General or the Governor.

Therefore the system of financial control, both at the time of budget formulation and approval for incurring expenditure, turned out to be very rigid, rule-oriented and complex. This system naturally inhibited and suppressed any popular initiative towards change and development. Understandably, the control over financial administration was a necessary adjunct of the fundamental imperial objectives. It was never meant to facilitating solutions to national troubles. It was this system, with all its distortions and rigidities, which India inherited from the British.

PRINCIPLES OF BUDGETING

The essential principles usually observed in government budgeting in India are:

- Principle of annularity. The budget should be on an annual basis; this leads to another rule “the rule of lapse”. The operation of this rule leads to a rush of expenditure towards the end of the year. Though it has the merit of enforcing parliamentary sanction—which is always for an amount for a specific period after which it necessity be obtained again. This implies that if the funds voted are not used through the end of the financial year, the unspent balance lapses.
- The government budgets are on cash basis.
- There should be one budget for all financial transactions of the government. In the absence of one common budget it would be hard to assess the true financial position of the government. Railways and other public enterprises, though, have separate budgets. In the case of railways, total receipts and expenditure are incorporated in the Central Government Budget. The estimates of capital and loan disbursement

and also the extra budgetary possessions for financing the plans of public enterprises are also shown in the Central Budget.

- The budgeting should be gross and not net. Gross transactions, both in the case of receipts and expenditure of each department, should be shown. It is not permissible to deduct any receipt accruing to the department from the charges of collection or any other expenditure. This is planned to ensure that the parliamentary control over expenditure is meaningful. In the absence of this provision, the budget coming up before the Parliament would be reduced only to the net deficit, if any.
- Budgeting should be secure. It should not be guess work or guess estimates which result in wide fluctuations and can lead to improper allocation of funds, supplementary grants.
- The form of estimates should correspond to the accounting heads since the estimates eventually get converted into actual accounts of receipts and expenditure.

FINANCIAL YEAR

When the first modern budget was presented in I860, the financial year adopted through the government was from 1st May to 30th April. Beginning with the year 1866, though, the financial year was changed to April-March, in conventionality with the practice in England. This practice has been the subject of debate and several committees and commissions which examined the issue have been critical of it. The Administrative Reforms Commission in its Report on Finance, Accounts and Audit observed.

- "The financial year starting from the 1st of April is not based on custom and needs of our nation. Our economy is still predominantly agricultural and is dependent on the behaviour of the principal monsoon. A realistic financial year should enable a correct assessment of revenue, should also synchronies with a maximum continuous spell of working season and facilitate an even spread of expenditure. For centuries, people in India have become accustomed to commence their financial year on the Diwali day. This practice has its roots in their way of life. The business community and other sections of society start the Diwali day with the feeling that they have finished with the old period of activity and have embarked upon a new one. It is, so, appropriate that the commencement of the financial year should be related to Diwali and in order to prescribe it in conditions of a date, we have recommended that the 1st November should be the beginning of financial year."

The commission also thought that a budget year commencing on the 1st

November would be better suited for the transaction of Parliamentary business. It is normally argued that the effect of south-west monsoon, which is responsible for over 90 per cent of the total annual rainfall in India, would be recognized through September, and the likely agricultural production throughout the year can be estimated fairly accurately. The commercial and industrial activities are also largely dependent on the performance in the agricultural sector. Besides, the monsoon months can be utilized for budget formulation and the critical fiscal parameters can be decided upon in the light of anticipated stage of economic activity in the ensuing year.

Under the present arrangements, soon after the expenditure sanctions reach the executing agencies, the onset of monsoon renders it hard to start construction of the budgeted works. These works have to wait till the rains are over. The speed of works is affected because of the intervention of monsoons when barely the preparatory work of projects has been completed. The delayed execution of works results in the rush of expenditure towards the end of the year leading to surrender of funds at the secure of the financial year. Essentially a budget year should help in performing the following functions:

- Creation a fairly accurate estimates of revenue;
- Creation a fairly accurate estimates of expenditure;
- It should facilitate an efficient execution of projects; and
- The budget calendar should be convenient to the legislators and administrators.

Dissimilar dates have been suggested through the several experts who have examined the question of financial year. These are 1st July, 1st October, 1st November or 1st January. While there is a merit in each one of these suggestions, none of these can reconcile the conflicting criteria proposed. Considering only the criterion of better predictability of revenues, no single budget year gives enough scope for the several states to create a realistic assessment for both Kharif and Rabi crops. Rabi crops are very significant for some of the states. The estimation of total agricultural production would, so, remain a guess work.

It has, so, been argued that the balance of advantage lies in not disturbing the present fiscal year. The database of the economy relates to the existing financial year and any dislocation in this year will lead to statistical, accounting and administrative troubles. One has to weigh the advantages of changing over to a dissimilar fiscal year against the disadvantages inherent in such a switchover. And one has to keep in mind that there is no general agreement on the alternative fiscal year. The only practical approach, so, is to continue with the present financial year.

THE BUDGETARY PROCEDURE

With the attainment of Independence, the objectives, the policy framework and the environment of financial administration underwent a radical change. The disagreement flanked by popular will and aspirations and the policy and procedures which had characterized financial administration in the country disappeared overnight. Even though the vital characteristics of the Government of India Act, 1935, with regard to financial administration, were retained, there was no fundamental disharmony flanked by these instruments and the national priorities. These instruments could be and were refashioned according to the changed objectives.

The budgetary processes in India follow the procedure laid down in Articles 112 to 117 of the Constitution. Accordingly, annual budget of the Union, described the Annual Financial Statement of estimated receipts and expenditure, is to be laid before both Houses of the Parliament in respect of every financial year. The Budget shows the receipts and payments of government under three parts in which government accounts are kept:

- Consolidated Fund,
- Contingency Fund, and
- Public Account.

Consolidated Fund of India

All revenues received through government, loans raised through it, and also its receipts from recoveries of loans granted through it form the Consolidated Fund. All expenditure of government is incurred from the Consolidated Fund and no amount ban be withdrawn from the fund without authorization from the Parliament.

Contingency Fund

Occasions may arise when government may have to meet urgent unforeseen expenditure pending authorization from the Parliament. The Contingency Fund is an Imprest placed at the disposal of the President to incur such expenditure. Parliamentary approval for such expenditure and for withdrawal of an equivalent amount from the Consolidated Fund is subsequently obtained and the amount spent from Contingency Fund is recouped to the fund. The corpus of the fund authorized through the Parliament, at present, is Rs. 50 crore.

Public Account

Besides the normal receipts and expenditure of government which relate to the Consolidated Fund, sure other transactions enter government accounts, in respect of which government acts more as a banker; for instance, transactions relating to Provident Funds, small savings collections, other deposits etc. The moneys therefore received are kept in the Public Account and the linked disbursements are also made therefrom. Usually speaking, Public Account funds do not belong to government and have to be paid back some time or the other to the persons and authorities who deposited them. Parliamentary authorization for payments from the Public Account is, so, not required.

Charged Expenditure

Under the Constitution, sure items of expenditure like emoluments of the President, salaries and allowances of the Chairman and the Deputy Chairman of the Rajya Sabha and the Speaker and Deputy Speaker of the Lok Sabha, salaries, allowances and pensions of Judges of the Supreme Court and the Comptroller and Auditor-General of India, interest on and repayment of loans raised through government and payments made to satisfy decrees of courts etc; are charged on the Consolidated Fund. These are not subject to the vote of Parliament. The budget shows the charged expenditure separately in the Consolidated Fund. Government budget comprises:

- Revenue budget; and
- Capital budget

Revenue Budget

It consists of the revenue receipts of government (tax and non-tax revenues) and the expenditure met from these revenues. The estimates of revenue receipts shown in the budget take into account the effect of the taxation proposals made in the Finance Bill. Other receipts of government mainly consist of interest and dividend on investments made through government, fees, and other receipts for services rendered through government.

Capital Budget

It consists of capital receipts and payments. The main items of capital receipts are loans raised through government from public which are described Market Loans, borrowings through government from Reserve Bank and other parties through sale of Treasury bills, loans received from foreign governments and bodies and recoveries of loans granted through Central

Government to State and Union Territory governments and other parties. Capital payments consist of capital expenditure on acquisition of assets like land, structures, machinery, equipment, as also investments in shares etc. and loans and advances granted through Central government to State and Union Territory governments, government companies, corporations and other parties. Capital budget also incorporates transactions in the Public Account.

Demands for Grants

The estimates of expenditure from the Consolidated Fund incorporated in the budget and required to be voted through the Lok Sabha are submitted in the form of Demands for Grants. Usually, one Demand for Grant is presented in respect of each ministry or department. Though, in respect of large ministries or departments, more than one demand is presented. Each demand normally comprises the total provisions required for a service, that is, provisions on account of revenue expenditure, capital expenditure, grants to State and Union Territory governments and also loans and advances relating to the service. Where the provision for a service is entirely for expenditure charged on the Consolidated Fund, for instance, interest payments, a separate appropriation, as separate from a demand, is presented for that expenditure and it is not required to be voted through Parliament. Where, though, expenditure on a service comprises both 'voted' and 'charged' items of expenditure, the latter are also incorporated in the demand presented for that service but the 'voted' and 'charged' provisions are shown separately in that demand.

Plan expenditure forms a sizeable proportion of the total expenditure of the central government. The Demands for Grants of the several ministries show the plan expenditure under each head separately from the non-plan expenditure. The document also gives the total plan provisions for each of the ministries arranged under the several heads of development and highlights the budget provisions for the more significant plan programmes and schemes.

A large part of the plan expenditure incurred through the central government is through public sector enterprises. Budgetary support for financing outlays of these enterprises is provided through government either through investment in share capital or through loans. The budget shows the estimates of capital and loan disbursements to public sector enterprises in the current and the budget years for plan and non-plan purposes and also the extra-budgetary possessions accessible for financing their plans.

The Railways and Telecommunication services are the principal departmentally-run commercial undertakings of government. The budget of the Railways and the demands for grants relating to Railway expenditure are presented to parliament separately. Though, the total receipts and expenditure of the Railways are incorporated in the Central Budget. The demands for grants of the Department of Telecommunications are presented beside with other demands of the central government.

BUDGETARY CYCLE

In order to allow time for the executive and legislative processes to go through, budgeting is geared to a cycle. The procedure of approval is very important in a responsible form of government. The cycle consists of four stages:

- Preparation and submission;
- Approval;
- Execution; and
- Audit

At any given point of time, manycycles would be in operation and would be Overlapping/Nevertheless, several segments of a cycle have dissimilar operational life.

Budget Preparation

In India, budget preparation formally begins on the receipt of a circular from the Ministry of Finance sometime throughout September/October, that is, about six months before the budget presentation. The circular prescribes the time-schedule for sending final estimates separately for plan and non-plan, and the guidelines to be followed in the examination of budget estimates to be prepared through the department concerned

The general rule is that the person who spends money should also prepare the budget estimates. Budget proposals normally contain the following information:

- Accounts classification
- Budget estimates of the current year
- Revised estimates of the current year
- Actual for the previous year; and Proposed estimates for the after that financial year (which is the budget proper). Budget estimates normally involve:
    - Standing charges or committed expenditure on the existing stage of service. This can easily be provided for in the budget, as it is more or less based on a projection of the existing trends.

- New expenditure which may be due to expansion of programmes involving expenditure in addition to an existing service or facility; and new service for which provision has not been previously incorporated in the grants.

The budget estimates prepared through the ministries/departments according to budget and accounts classification are scrutinized through the Financial Advisors concerned. The plan items of the Central Budget are finalized in consultation with the Planning Commission and are based on the Annual Plan.

Parliamentary Approval

The estimates of expenditure prepared through ministries/departments are transmitted to the Ministry of Finance through December where these are scrutinized, modified where necessary and consolidated. The estimates of revenue are also prepared through the Finance Ministry and therefore the budget is finalized. The budget is presented to the Parliament usually on the last working day of February. In the first stage, there is a general discussion on the broad economic and fiscal policies of the government as reflected in the budget and the Finance Minister's speech. This lasts about 20-25 hours.

In the second stage, there is a detailed discussion on the demands for grants, usually in respect of specific ministries or departments. Each demand for grant is voted separately. At this stage members of parliament may move motions of several types. Usually these are policy cuts, economy cuts, and token cuts. The policy cut motion seeks to reduce the demand to rupee one and is indicative of the disapproval of general or specific policy underlying the service to which the demand pertains. The motion for economy cut is to reduce the proposed expenditure through a specified amount. A token cut in a demand is moved to reduce it through a nominal amount say Rs. 100 and may be used as an occasion to ventilate a specific grievance. Since it is never possible to accommodate a detailed discussion on each demand for grant separately, the demands that cannot be so discussed are clubbed together and put to the vote of the Parliament at the end of the period allotted for discussion.

Though the budget is presented before both Houses of Parliament, the demands for grants are submitted only to the lower house. Demands for grants, are the executive’s requisitions for sanction to spend, and only the lower house can have a say in the matter. While the legislature can object to a demand for grant, reject it or reduce it, it cannot augment the same. It may also be mentioned here that since no demand for a grant can be made except on the recommendations of the President or the Governor (in the case of State); private members cannot propose any fresh items of expenditure. If this were allowed it would necessitate revision of receipts and consequently the budget and sometimes may lead to improper appropriation of public funds.

Even after the demands for grants have been voted through the Parliament, the executive cannot draw the money and spend it. According to the Constitutional provisions, after the demands for grants are voted through the Lok Sabha, Parliament's approval to the withdrawal from the Consolidated Fund of the amount so voted and of the amount required to meet the expenditure charged on the Consolidated Fund is sought through the Appropriation Bill. The Appropriation Bill after it receives the assent of the President becomes the Appropriation Act. Therefore, without the enactment of an Appropriation Act, no amount can be withdrawn from the Consolidated Fund.

Since the financial year of the government is from 1st April to 31st March, it follows that no expenditure can be incurred through the government after 31st March unless the Appropriation Act has been passed through the secure of the financial year. This is usually not possible as the procedure of discussion of the budget usually goes on up to the end of April or the first week of May. Therefore, in order to enable the government to carry on its normal activities from 1st April till such time as the Appropriation Bill is enacted, a Vote on Account is obtained from Parliament through an Appropriation (Vote on Account) Bill.

The proposals of government for levy of new taxes, modification of the existing tax structure or continuance of the existing tax structure beyond the period approved through Parliament are submitted to Parliament through the Finance Bill. The members can utilize the occasion of discussion on the Finance Bill to criticize government policies, more specifically the proposals concerning the taxation and tax laws. In sure cases, taxation proposals take effect immediately. Since, though, passing of the Finance Bill may entail a time lag, a mechanism under which the taxation proposals take effect immediately pending the passing of the Finance Bill exists in the form of Provisional Collection of Tax Act, 1931, which empowers the government to collect taxes for a period of 75 days till the Finance Bill is passed and comes into effect.

The budget of the Central Government is not merely a statement of receipts and expenditure. Since Independence, with the launching of five year plans, it has also become an important statement of government policy. The budget reflects and shapes, and is in turn shaped through, the country's economic life. A background of the economic trends in the country throughout the current year enables a better appreciation of the mobilization of possessions and their allocation as reflected in the budget. A document, Economic Survey, is prepared through the government and circulated to the members of Parliament a couple of days before the budget is presented. The Survey analyses the trends in agricultural and industrial production, money supply, prices, imports and exports and other relevant economic factors having a bearing on the budget.

Execution of the budget

The execution of the budget is the responsibility of the executive government. The procedures for execution of the budget depend on the sharing and delegation of powers to the several operating stages. As soon as the Appropriation Act is passed, the Ministry of Finance advises spending Ministries/ Departments about their respective allocation of funds. The controlling officers in each ministry/department then allocate and advise the several disbursing officers. The expenditure is monitored to ensure that the amounts placed at the disposal of the spending authorities are not exceeded without additional funds being obtained in time. Therefore the financial system broadly consists of the following stages:

- Controlling officers; normally the head of the ministry/department acts as the controlling officer;
- A system of competent authorities who issue financial sanction;
- A system of drawing and disbursing officers; and
- A system of payments receipts and accounts.

The Department of Revenue in the Ministry of Finance is in overall control and supervision over the machinery charged with the collection of direct and indirect taxes. Such control is exercised through the Central Board of Direct Taxes and the Central Board of Indirect Taxes. These Boards exercise supervision and control over the several operational stages which implement dissimilar taxation laws. The Reserve Bank of India is the central banker of the government. The nationalized banks and the network of treasuries are also performing the service of collection (receipts) and disbursement of funds.

Audit

The executive spends public funds as authorized through the legislature. In order to ensure accountability of the executive to the legislature, public expenditure has to be audited through an independent agency. The Constitution gives for the position of the Comptroller and Auditor General of India to perform this function. It is his/her duty to ensure that the funds allocated to several agencies of the government have been made accessible in accordance with law; that the expenditure incurred has the sanction of the competent authority; that rules, orders & procedures governing such expenditure have been duly observed; that value for money spent has been obtained and that records of all such transactions are maintained, compiled and submitted to the competent authority. This is the last stage in completing the budgetary cycle.

GOVERNMENT BUDGETING: PRINCIPLES AND FUNCTIONS

BUDGET-MEANING

A budget is a statement containing a forecast of revenues and expenditures for a period of time, usually a year. It is a comprehensive plan of action intended to achieve the policy objectives set through the government for the coming year. A budget is a plan and a budget document is a reflection of what the government expects to do in future. While any plan need not be a budget, a budget has to be necessarily a plan. It shows detailed Allocation of possessions and proposed taxation or other measures for their realization. More specifically, a budget contains information about:

- Plans, programmes, projects, schemes and activities—current as well as new proposals for the coming year;
- Resource position and income from dissimilar sources, including tax and non-tax revenues;
- Actual receipts and expenditure for the previous year; and
- Economic, statistical and accounting data concerning financial and physical performance of the several agencies and organs of the government.

A budget is, though, not a balance sheet (exhibiting total assets and liabilities) of the government on a scrupulous date but refers, only to information explained above. It is a financial blueprint for action and is so, of great advantage to government departments, legislatures and citizens.

FEATURES OF BUDGET

The vital features of government budgeting is as follows:

- There is a strong emphasis on expenditure control with itemized ceilings and sanctions. The French system of budgeting is largely based on this principle, viz.: a strong financial control system. For historical and administrative reasons, Indian budgetary system is also set in a framework of strong financial control. Although, after

Independence, this characteristic has become diluted through several schemes of delegation of powers and decentralization.

- Another feature is the tendency towards instrumentalism. The bulk of ongoing activities are left untouched. Only marginal adjustments are made in raising and allocating possessions from one year to the other. In spite of several budgetary innovations, budgetary systems the world over are essentially incremental in nature.
- There is usually no attempt to relate inputs to outputs or expenditure to performance and benefits. Any such attempt, if at all it is made, is limited to the economic function and the largest component of government activities, perse, are mainly expenditure-oriented.
- Usually budgets are prepared for a time span of one year. Since budgeting presupposes planning it must, so, adopt a longer time frame.
- Some of the budgetary systems (Netherlands) reflect application of commercial principles to budget, including provision of depreciation allowances and in some systems, accrual-based accounting. The Italian budgetary system shows the availability of funds beyond the financial year with parallel operation of the preceding and current year’s budgets.
- In some countries, special accounts are maintained (Japan) and these are outside the budgetary procedure.

FUNCTIONS OF BUDGET

A budget is a powerful instrument in the hands of government. It has manifold objectives. Some of these are as follows.

Accountability

In the early stage, legislative control and accountability were the primary functions of the government budget. This arose from the legislature’s desire to control (impose, amend and approve) tax proposals and spending. The executive was accountable to the legislature for spending—within limits approved through the latter, under many heads of expenditure, and only for approved purposes. Similar accountability was to exist within the executive on the part of each subordinate authority to the one immediately above in the hierarchy of delegation. Accountability continues to be a significant function of the government budget even today owing to its usefulness in budget execution and plan implementation.

Management

Budgeting is an executive or managerial function. As an effective tool of management, budgeting involves planning, coordination, control, evaluation, reporting and review. Several of the budgetary innovations such as:

- Functional classification,
- Performance measurement through norms and standards,
- Accounting classification to correspond to functional classification,
- Costing and performance audit and use of quantitative techniques
- Have become significant aids to management. Several budgetary systems like performance budgeting and zero base budgeting are specifically management-oriented systems.

Control

Control essentially implies a hierarchy of responsibility, embracing the whole range of executive agencies, for the money composed and expenditure, within the framework of overall accountability to the legislature. In a democracy, control assumes new dimensions and gives rise to exceedingly hard troubles. The vital concern in a truly representative government is to bring about appropriate modifications in the design and operation of the financial system so as to ensure executive responsibility to the legislature which is the law-creation, revenue determining and fund-granting authority.

Legislative control would mean that the legislature can meaningfully, and not merely formally, participate in the formulation of broad policies and programmes, their scrutiny, approval and implementation through the annual budget. It also means that the legislature can effectively relate performance and attainment of the executive to the objectives and policies as laid down through it.

Members of the legislature are not always adequately acquainted with the complexities of financial administration, nor can they always understand the enormity of the vast scale of operations and so the stage of funds required. Several devices are, so, used to assist legislatures in exercising their legitimate powers over the executive. The Congressional committees of the United States and the Parliamentary Select committees of the United Kingdom and India help the legislature in exercising their control over the public purse.

Statutory audit also examines the accounts and other relevant records to ensure that the moneys granted through the legislature are spent strictly in accordance with law. Also, audit tries to ensure that the government obtains value for the tax-payers’ money and that the norms of economy, efficiency and effectiveness are observed.

Planning

Budgeting gives a plan of action for the after that financial year. Planning, though, involves the (i) determination of long term and short term objectives, determination of quantified targets, and (iii) fixation of priorities. Planning also spans a whole range of government policies keeping the time factor and interrelationships flanked by policies in view. Planning envisages broad policy choices. At the stage of projects and programmes, the choice is flanked by alternative courses of action so as to optimize the resource utilization. The goals of public sector, viz., (i) optimal allocation of possessions, (ii) stabilization of economic activity, (iii) an equitable sharing of income, and (iv) the promotion of economic growth are all pursued in an organizational context. In the short-run, attainment of these goals has to be co-ordinate through means of administrative and legal instruments in the middle of which budget policy and procedure are the mainly significant. Planning in the budget procedure reflects political pressures as well as financial pressures and financial analysis.

CLASSIFICATION OF BUDGETS

Information on the working of the budgetary procedure is obtained from the systems of classification. Since such a procedure has a multitude of functions and objectives, dissimilar kinds of classification are needed, either singly or in combination to serve the purpose of appropriation, programme management and review, evaluation of plan implementation and financial and economic analysis. Transactions of the government can be classified through

- Objects such as salaries, wages etc.;
- Organisation or department;
- Functions such as defense, education, agriculture, etc.;
- Their economic character such as consumption expenditure, capital formation, etc.

The system of classification of expenditure is a very significant characteristic of the budget for the fulfillment of budgetary functions. It is through the classification system that the managerial potential of budgeting procedure may be realized. Let us now discuss some of the mainly significant classification systems. They are:

- Object-wise or line-item or traditional classification
- Functional classification
- Economic classification

Object-wise Classification

Traditional budgeting ensures control of expenditure and the need to ensure accountability of the executive to the legislature as well as that of the subordinate formations of the executive to the higher echelons. The budget is divided into sections according to organizational units, departments, divisions and expenditure is detailed through each category such as salary, wages, etc. A typical classification would be as follows:

- Salary
- Wages
- Traveling allowance
- Office expenses
- Machinery and equipment
- Works
- Grants-in-aid
- Other charges
- Suspense account

Merits

- As already stated, the rationale for this kind of classification was the need to facilitate control and accountability. Inter-agency, inter-organisation and interdepartmental comparison of expenditure could easily be made. This information would also be accessible on a time-series basis, that is, from year to year, so that the departments concerned could be pulled up if the expenditure trends, as revealed through this classification, were not satisfactory.
- It shows clear allocation of funds. For instance, what percentage of the expenditure is on salaries, traveling allowances, etc?
- In times of financial stringency, this classification enables crossways-the-board cuts on specific heads such as traveling allowances, foreign travel etc.

Demerits

- The vital philosophy of budgets with this kind of classification is that spending the budgetary allocation is in itself a virtue. Whatever the amount allocated to a scrupulous object it has to be spent, without emphasis on the likely outcome of that expenditure. Since control is not related to performance, it easily degenerates into wastefulness and extravagance. Performance therefore takes a back seat.
- Emphasis is laid on procedural thoughts, legality and regularity of expenditure and all the complex rules that are framed to satisfy

regularity audit. Evaluation, justification for expenditure and obtaining value for money become only incidental.

- Inadequate information is accessible about the government's objectives and programmes. The emphasis on control and accountability exerts an influence on the criteria which govern budget decisions. Programme control, contribution to development, programme co-ordination and efficient resource allocation are neglected.
- Any duplication, redundant activities and expenditure are hard to detect and avoid.
- It is only the mainly pressing demands which receive attention of the budget makers. Policies, programmes and projects which have only long term benefits, usually get postponed year after year.

Functional Classification

Performance budgeting is based on a "conviction that the way in which revenue and expenditure are grouped for decision creation is the mainly significant characteristic of budgeting". A functional classification of the budget is necessary under the system of performance budgeting. The presentation of budgeted expenditure should, so, be in conditions of functions, programmes, activities and projects. Such a classification is an aid to the managerial function of performance measurement relative to the costs incurred. The output of a programme/activity in conditions of physical targets has to be related to the inputs required. These are translated into financial conditions and shown as the budget provision asked for the implementation of the programme/activity. The scheme of functional classification is outlined below:

FUNCTIONAL CLASSIFICATION

Term	**Definition**		Examples
Function	A major division of governmental	1)	Education
	efforts which provides distinct	2)	Health
	services.	3)	Defence
		4)	Agriculture
Programme	A segment of a function usually	1)	Elementary
	having an end identifiable		education
	with a major organisation.		Secondary education
			Higher education
			Technical/ Vocational
			education
		2)	National Malaria
			Eradication Programme
		3)	Development of High
			Yielding Crops
Activity/	A division of a programme	1)	Construction of school
Project	into homogeneous types of		buildings
	work or schemes		Strengthening of
			laboratories
		2)	Purchase of seeds/
			fertilisers

Economic Classification

The budget of the government has an impact on the economy as a whole. Because of its sheer magnitude, receipts and expenditure of the government and several policies that are articulated through the budget are easily the mainly important factors that can and do change the very nature, content and direction of the economy. It is, so, significant to group the budgetary provisions in conditions of economic magnitudes, for instance, how much is set aside for capital formation, how much is spent directly through the government and how much is transferred through government to other sectors of the economy through way of grants, loans, etc. Economic classification categorizes government's total expenditure into meaningful economic heads like investment, consumption, generation of income, capital formation etc. According to the Economic and Social Council of the United Nations (Economic classification gives) "an analysis of the transaction of Government bodies according to homogenous economic categories of transactions with the other sectors of the economy directly affected through them". This analysis is contained in a separate document described Economic and Functional Classification of the Central Government Budget, and is brought out through the Ministry of Finance. A broad categorization is as follows:

Economic Classification of Total Expenditure

- Consumption Expenditure
    - Defense
    - Other Government Administration
- Transfer Payments (current)
    - Interest Payments
    - Subsidies
    - Grants to States and Union Territories
- Gross capital formation of budgetary possessions
    - Physical Assets
    - Financial Assets

An annual comparison would show whether the expenditure on capital formation is rising or declining. A decline would be due to augment either in consumption expenditure or in the transfer payments, say interest.

FISCAL POLICY, EQUITY AND SOCIAL JUSTICE

FISCAL POLICY—MEANING

Broadly speaking, fiscal policy is concerned with raising and spending financial possessions and public debt operations to influence the economic activities of the community in desired ways. It is also concerned with the allocation of possessions flanked by the public and private sectors and their use in accordance with national objectives and priorities. It aims at using its three major instruments—taxes, public expenditure and public debt—as balancing factors in the development of the economy.

According to Preached "Formulation of fiscal policy presumes the identification and clear recognition of the institutional characteristics of government finance, such as tax systems, their incidence and shifting, budget formulation and execution, and financial management." Since the state has come to occupy a pivotal role in the economic development of a country, fiscal policy is being increasingly used, through a policy of taxation of income, commodities, imports and exports, a well intended policy of public expenditure and a policy of borrowings, to influence the economic development of the country. Government budgeting is clearly the mainly significant instrument through which the fiscal policy is channelled. In fact, fiscal policy has come to be recognized with budgetary policy and the two conditions are often used interchangeably.

OBJECTIVES OF FISCAL POLICY

The significant objectives of fiscal policy contain:

- To augment the rate of capital formation: In order to promote and sustain economic development, the rate of capital formation has to be much higher than that prevailing in mainly of the underdeveloped countries. A high rate of economic growth, sustained over a long period is an essential condition for achieving a rising stage of living. Since an augmenting the rate of growth does not come about automatically, the main objective of fiscal policy is to allocate more possessions for investment and to restrain consumption.
- Reduction in economic inequalities of income and wealth: A major contribution of fiscal policy consists in minimizing the adverse distributional impact of government policies. For instance, in a developing country like India, the need for alleviation of poverty is self-apparent. There is, though, yet no proof that the procedure of economic development has had any positive economic impact on the impoverished classes. Mobilization of possessions for financing the anti-poverty programmes, such as Integrated Rural Development Programme, Jawahar Rozgar Yojana, employment guarantee schemes,

etc., is a significant objective of fiscal policy in India. In any case, in a democratic society political realities would not permit a further widening of the sharing patterns than at present. Either through itself, or in conjunction with other measures of social and economic reforms, the current fiscal policy has considerable potential for reducing inequalities of income. Cumulative inequalities may take time to melt absent.

- Balanced growth: A primary characteristic of the economic scenario in developing countries is their excessive dependence on agriculture rather than on industries and other non-agricultural occupations. The procedure of economic development gives rise to a greater diversity of economic occupations, lesser dependence on land, and the need to give employment to additional labour which results from mounting population pressure. Balanced development not only crossways income groups, but also crossways regions in the country can be achieved through appropriate fiscal policy instruments. Another type of balance is that flanked by the public sector and the private sector. There is no such thing as a pure market economy or a total centrally planned economy. Once the appropriate mix and the economic role of the state have been decided on, fiscal policy instruments are pressed into service to bring about the desired policy changes.
- Economic and social overheads: Fiscal policy has to be so formulated that adequate possessions are accessible to the government for funding social expenditure which benefit the poor. Heavy investments have to be made in infrastructure for sustaining growth in agriculture and industry. The development of transport and communication, water management and irrigation projects, large scale investments in health and education, cannot be left to the private sector. Such investments are heavy and usually beyond the capability of the private sector. Private sector is usually interested in projects with adequate and quick returns. The government, so, has to have a fiscal policy which will allow such investments in social overheads. Such investment will allow private capital to come in and through raising the productive capability and production, the government can generate profits.
- Control of inflation: There are several causes of inflation. There can be too much money in the hands of people and two few goods and services accessible for buying. An augment in government expenditure results in an augment in payment of salaries, wages, purchase of goods and services. This puts more income in the hands of the people. An augment in wages of industrial workers also increases money income. Wages also constitute costs of inputs. If costs go up, so do prices. This is cost-push inflation. Therefore inflation results either because there is too much demand (because of increased purchasing power) for too few goods or because the costs of inputs having gone up the prices rise. An appropriate fiscal policy can help in controlling inflation. A non-

inflationary financing of planned development will require a greater reliance on surplus generated through the budget and public sector undertakings and a reduced dependence on borrowed funds.

- Progressive tax structure: Taxes and subsidies have direct consequences for the poor to the extent that they bear the burden of taxes or benefits from the subsidies. In a developing country like India, the tax structure relies heavily on indirect taxes. This is not surprising, given the stage of development, low income stages of the majority of the people and the scope for commodity taxes offered through the growth of industry and trade. The government should try to augment the scope of the indirect tax system, both through low tax rates on essential commodities and through subsidized sharing of food grains, edible oils and sugar.

At the same time, an effort has to be made to augment the share of direct taxes in total tax revenue over a period of time, so that the fiscal system as a whole becomes progressive. What matters, though, are not the tax rates on paper, but the actual collections and their incidence? Fiscal policy must, so, ensure that taxes, as levied, are fully composed and strong action is taken to curb tax evasion.

FISCAL POLICY IN OPERATION—SOME HIGHLIGHTS

Control of Inflation

Currently, inflation has been described as the mainly significant problem that the economy is faced with. A number of demand-pull and cost-push factors have been mentioned as potential causes. The inflationary surge is led mainly through agricultural goods. The prices of manufactured goods have not even kept pace with average inflation, and, have lagged well behind the rise in agricultural prices. Beside with demand-pull factors, supply factors (scarcity or short supply) have determined the pattern of relative price changes. Agricultural prices were increased through a rather poor kharif crop of 1990 which followed on the heels of a poor rabi crop earlier in the same year. Imports could not be used to augment supplies and dampen prices because of the severe balance of payments problem being faced through the economy. The sharp increases in procurement prices for food grains have also contributed to the inflationary pressure.

The excess demand pressures in the economy were primarily generated through expansionary fiscal policies of the central and state governments. Firstly, the investment expenditure of the government has far exceeded their savings. The excess demand of the government represented through its excess over saving has been met from these sources: (1) domestic borrowing; (2) foreign borrowing; and (3) borrowing from Reserve Bank of India. While borrowing from the commercial banking system cannot go beyond a point, foreign borrowings are also no longer freely accessible to finance excess of expenditure over receipts from domestic borrowings. If the recourse to foreign borrowings is to be reduced, either domestic investment necessity is reduced, with undesirable consequences, or domestic savings necessity be raised.

The third source for borrowings is the Reserve Bank of India. This is directly linked to the expansion of money supply and consequently to inflation. The monetized deficit (that is, the part of the fiscal deficit that leads to an augment in money supply) has been rising. The monetized deficit of the central government shows a fair degree of correspondence with the rate of inflation. Separately from the immediate net augment in expenditure, monetization of the deficit builds up a stage of liquidity which leads to a general augment in demand, and hence inflation, in the succeeding years. Therefore the government needs to reduce its reliance on all the three present sources of funds: compulsory borrowings through the banking system, the monetized deficit and foreign borrowings.

In order to reduce the fiscal deficit, the government has had to permit an augment in the administered prices of some vital goods and services. It incidentally increased input costs in the rest of the economy, thereby bringing about cost-push inflation also. Devaluation of the rupee in July, 1991 led to an augment in import costs. In order to combat inflation, the Government launched a massive effort to correct the fiscal imbalance through reducing the fiscal deficit from 8.4 per cent of Gross Domestic Product (GDP) in 1990-91 to 6.5 per cent in 1991-92 and further to about 5 per cent in 1992-93. Other measures in this direction contain

- Containing the growth of aggregate demand;
- Tightening of selective credit controls; and
- Revamping and extending the public sharing system.

Balance of Payments

The domestic and external sectors of an economy are interrelated. When domestic income is equal to domestic expenditure, the external accounts are in balance. Excess domestic demand caused through an excess of investment over saving leads to domestic inflation. It can also result in a deficit in the balance of payments.

India entered the decade of nineties with large internal and external financial imbalances which made the economy highly vulnerable to external shocks. The Gulf crisis resulted in a higher import bill and a further loss of export markets and remittances. External commercial borrowings declined sharply. The drying up of commercial loans was accompanied through a substantial net outflow of deposits through Nonresident Indians. The rapid loss of reserves prompted the government to take a number of counter measures leading to a reduction in imports. Import reduction beyond a point would affect the entry of the essential inputs into industry and transport, petroleum products and fertilizers. This led to a decline in industrial production and a fall in exports as import compression had reached a stage when it threatened widespread loss of production and employment and verged on economic chaos. The government, so, moved to implement a programme of macro-economic stabilization through fiscal correction.

A key element in the stabilization effort was the attempt to restore fiscal discipline. Both the balance of payments troubles which were structure up over the past few years and the persistent inflationary pressure were the result of large budgetary fiscal deficits which characterized the economy year after year. The budget deficit was about Rs. 11,000 crore in 1990-91. A reversal of the trend of fiscal expansionism was essential to restore macro-economic balance in the economy. The budget for 1991-92 brought down the deficit to about Rs. 7,000 crore. Likewise, reduction in the fiscal deficit (the overall resource gap of the Government) was envisaged through about two percentage points from around 8.4 per cent of GDP to 6.5 per cent of GDP. This was to be followed through a further reduction in 1992-93 to 5 per cent of the GDP.

These improvements in fiscal performance were made possible through the decision to abolish export subsidies, augment fertilizer prices, as well as the steps taken to keep non-plan expenditure (including defense expenditure) in check. These measures have reduced total expenditure, thereby reducing the current account deficit. These fiscal policy measures have been complemented through (i) exchange rate adjustment (devaluation of the rupee), (ii) a programme of structural reforms of trade, and (iii) industrial and public sector policies. The objective is to evolve an industrial and trade policy framework which would promote efficiency, create the economy internationally competitive, promote exports and usually integrate the Indian economy with the global economy. While the crisis has blown over, the policy reforms introduced through the government are necessary from the long term point of view.

Cut in Expenditure

Ever since the beginning of the planning era in India, the central government expenditure has increased enormously. The total expenditure which was Rs. 529 crore in 1950-51 has gone up to Rs. 1,19,087 crore in 1992-93 (budget estimates), an augment of 225 times. Revenue expenditure has grown at a faster rate. It went up from Rs. 347 crore in 1950-51 to 89,570 crore in 1992-93. Capital expenditure, though, grew at a slower pace. It increased from Rs. 183 crore in 1950-51 to Rs. 29,517 crore in 1992-93, an augment of 161 times. All this when the national income throughout the same period went up from Rs. 8,938 crore to Rs. 4,25,672 crore (estimated), which is about 48 times.

Another disturbing characteristic of the Union Budgets is the mismatch flanked by revenues and expenditure of the wrong type. Beginning with second plan right up to fifth plan, the revenue account of the budget always had a surplus and this partly offset the deficit in the capital account. But throughout the sixth plan the revenue account no longer assumed the "compensatory role". Beginning 1988-89, the capital account has been showing a surplus and therefore playing the reverse role of moderating the revenue account deficit. Therefore the plain meaning of this situation is that the government cannot raise enough revenues to sustain the ordinary business of governing the country. It has to borrow from the capital market to pay for its day to day expenses.

What an underdeveloped country should aim at is to have a surplus in its revenue account through raising maximum possessions, through taxation, and through keeping the consumption expenditure as low as possible. This surplus should be used to finance the capital budget. The deficit on the revenue account is either an index of an inadequate tax policy or possible extravagance in public expenditure on consumption or both. Such deficits would mean negative savings and consumption of capital.

The effect of deficit financing is to cause a rise in the domestic price stage and to generate demands for wages. This leads to an augment in prices of input costs creation the economy non-competitive. Substitution of foreign goods for domestic goods may lead to balance of payments troubles and depreciation of the exchange value of the rupee. A reduction in government expenditure, through reducing excess demand, will soften inflationary pressure. Can government expenditure be reduced? "The newly evolving analysis of bureaucracy through economists gives more rigorous underpinning for an old conclusion popularly recognized as 'Parkinsons Law'. Bureaucrats maximize their own utility and the principal variable in their "utility function" is power. Power can be roughly measured through a proxy such as the size of the bureaucrat's budget, or the size of the department through the number of employees. Bureaucrats identify themselves with the stated goals of their department and achieve their satisfaction in life in large part through expanding their activity. They will strongly resist any attempt to dismantle a government organisation. The governments, even when they create genuine efforts to reduce expenditure, usually do so through slowing down the rate of expenditure growth. Reduction in the absolute stage of expenditure is rarely possible. Dahl and Lindblom pointed out in ‘Income Stabilization in a Developing Democracy’ (Max Milliken, ed. Yale University Press, New Haven 1956), government expenditures usually mean that “services are performed, values are realized, administrative organisations developed, expectations expanded, clienteles shaped, interest groups created, pressures mobilized, and once these are set in motion, they cannot easily be contracted”.

The balance of payments crisis that overtook the government left it with no option but to take corrective fiscal action immediately. Containing and reducing non plan expenditure has been the avowed policy of the government for some years now. It is only with the budget for 1991-92 and 1992-93 that a serious effort has been made in this direction. The significant policy initiatives introduced in the 1991-92 budgets incorporated (i) reduction in the fertilizer subsidy; (ii) abolition of cash compensatory scheme; and (iii) disinvestment in some selected public sector enterprises. As a result of these adjustments, the provision for nonplan expenditure, excluding interest payments, in 1991-92, represented a reduction of about 5 per cent compared with the provision in the revised estimates for 1990-91, and a reduction of approximately 15 per cent in relation to what would have had to be provided, but for the fiscal correction.

Interest charges are the largest single item of nonplan expenditure and account for Rs. 32,000 crore in the budget estimates for 1992-93 and account for about 27 per cent of the total expenditure and about 38 per cent of the nonplan expenditure. The provision for 1992-93 represented an augment of Rs. 4,750 crore over the revised estimates for 1991-92. Interest charges are a committed expenditure reflecting the cumulative effect of past deficits. These charges can be controlled through reducing the reliance on borrowed funds, and creation the debts productive and self-liquidating. In the ultimate analysis, a reduction in revenue expenditure and hence revenue deficit can alone give a solution of lasting nature. This indeed is a daunting task. Expenditure on defense and subsidies are the other major components of nonplan expenditure. In real conditions, the defense expenditure has already been contained, if not marginally reduced. The question of subsidies is being investigated through a Parliamentary Committee.

In any effort at reducing expenditure and hence deficits, the first casualty usually is plan expenditure. Even though in nominal conditions, plan expenditure is marginally higher, in real conditions it represents an important reduction. This is in tune with the new economic philosophy of the government which accords larger economic space to the private sector. With this multipronged strategy, the government has been able to bring down the fiscal deficit from 8.4 per cent of the GDP (1990-91) to 6.2 percent in 1991-92 and hopes further to reduce it to approximately 5 per cent in 1992-93. This shows a welcome recognition of the paramount need to restore macro-economic balance and manage the balance of payments.

FISCAL POLICY—EQUITY AND SOCIAL JUSTICE

According to the long term fiscal policy, the major contribution of fiscal policy to poverty alleviation has to come through an effective programme for (i) mobilization of additional possessions which can be used for financing the anti-poverty programmes, (ii) for improving the social and economic services on which the poor mainly, rely and (iii) for financing the heavy investments in infrastructure, which are necessary for sustaining growth in agriculture and industry. The anti-poverty programmes and social services have to be financed through the government. Fiscal policy has to be so formulated that adequate possessions are accessible to the government for funding social expenditure which benefits the poor.

Alleviation of poverty has been an objective of the government policy, particularly after the fourth five year plan. Many special programmes have been in operation over the last two decades focusing on the poor as the target group. As a result, the extent of incidence of absolute poverty had declined over the years. The overall improvement in human possessions, as apparent from the estimates of incidence of poverty made through the Planning Commission, is given in the table below:

Estimates of Incidence of Poverty (per cent)

	1972-73	1977-78	1983-84	1987-88
1	2	3	4	5
Rural	54.1	51.2	40.1	33.4
Urban	41.2	38.2	.28.1	20.1
All India	51.5	48.3	37.4	29.9

The reduction in the incidence of poverty is being brought about both through (1) the growth of the economy, particularly in agriculture, and (2) through the implementation of development programmes especially intended to improve the income-earning opportunities of the poor. In the coming years, the Centre's expenditure policies will accord an even higher priority to programmes benefiting the poor, such as the Integrated Rural Development Programme, the National Rural Employment Programme and the Rural Landless Employment Guarantee Programme. In addition to the budgetary allocation for Rural Development programmes, an additional allocation (1992-93) is to be made accessible from the corpus of the National Renewal Fund for employment generation schemes to supplement the normal employment generation through the Jawahar Rozgar Yojana. An additional allocation of food grains, through the Public Sharing System, in the 1700 mainly backward blocks at a subsidized rate, is another step for protecting these vulnerable sections of society from the pressure on prices.

Another significant way in which fiscal policy can contribute to the reduction of poverty is to encourage rapid economic growth and fast expansion of productive employment opportunities. Taxation has important effects on savings and investment in the economy, on the allocation and uses of possessions flanked by alternative sectors, and on the efficiency with which possessions are utilized.

A progressive tax structure becomes inevitable if inequalities of income are to be reduced. Normal procedure of industrial development always benefits the affluent sections of society. It is from them that possessions can be mobilized for financing poverty alleviation programmes. Such a tax structure would rely heavily on direct taxes on income and wealth. Our tax structure, unluckily, relies largely on indirect taxes. The time is ripe to have a look at the tax system which has evolved over a long period and has become very complex. The taxation system has to be simplified, made more progressive so that none of our vital objectives of growth and social justice are compromised.

Food subsidy is a part of the system of food security for the poorer and weaker sections of the population and is a vital element in the social policy. This is being sustained. Fertilizer subsidy has become the largest single subsidy in the fiscal system. There is no doubt that fertilizer is an essential ingredient for agricultural production. Agricultural development is vital not only for economic growth in general, but also to ensure rising stages of income and employment in rural areas. In 1980-81, fertilizer subsidy was just 12 per cent of the total allocation in the Central and State Plans taken together, for Agricultural Rural Development Special Area Programmes and Irrigation and Rood Control. It increased to 33 per cent in 199192. Measures for better targeting and containing it are under investigation. For the present, this is being sustained.

Therefore ends of social justice and equity are being served through the fiscal policy. Once the economy goes through the macro-economic stabilization and structural reforms come to fruition, it should be possible to do much more in programmes of poverty alleviation, employment generation, public sharing systems, etc.

REVIEW QUESTIONS

- Highlight the vital characteristics of the financial system in India throughout the period 1858-1935.
- Distinguish flanked by revenue and capital budget.
- Explain the general features of budgeting systems.
- What is the central concern of fiscal policy? What are the major characteristics of government finance that fiscal policy is concerned with?
- Indicate the significant objectives of fiscal policy.

CHAPTER 3

BUDGETING AND BUDGETARY SYSTEM-II

STRUCTURE

- Learning objectives
- Zero base budgeting
- Performance budgeting
- Public expenditure: theories and growth
- Classification of government expenditure
- Review questions

LEARNING OBJECTIVES

After learning this unit, you should be able to:

- Explain the concept and meaning of zero base budgeting.
- Explain the concept and objectives of performance budgeting.
- Evaluate the several theories and approaches through dissimilar schools of thought concerning the determination of public expenditure.
- Explain the several classifications of government expenditure.

- Evaluate the present system of classification of government expenditure.

ZERO BASE BUDGETING

CONCEPT AND MEANING OF ZERO BASE BUDGETING

Zero Base Budgeting is a management procedure that gives for systematic consideration of all programmes and activities in conjunction with the formulation of budget requests. It is a system whereby each governmental programme, regardless of whether it is new or existing programme necessity be justified in its entirety each time a new budget is formulated. It implies that, in defense of its budget request no department shall create reference to the stage of previous appropriation. The analytical definition of Peter Sarant holds that "Zero Base Budgeting is a technique which complements and links the existing planning, budgeting and review procedure. It identifies alternative and efficient methods of utilizing limited possessions in the effective attainment of selected benefits. It is a flexible management approach which gives a credible rationale for re-allocating possessions through focusing on the systematic review and justification of the funding and performance stages of current programmes or activities." The objectives of Zero Base Budgeting according to the Department of Expenditure, Ministry of Finance, Government of India are:

- "Zero base budgeting requires identification and sharpening of objectives, examination of several alternative ways of achieving these objectives, selecting the best alternatives through cost-benefit and cost-effectiveness analysis, prioritization of objectives and programmes, switching of possessions from programmes with lower priority to those with higher priority and identification and elimination of programmes which have outlived their utility."

Zero Base Budgeting, therefore, is an operating, planning and budgeting procedure which requires each manager to justify whole budget requests in detail from scratch, and shifts the burden of proof to each manager to justify why any money should be spent at all, as well as how the job can be done better. This approach requires that (i) all activities be recognized in decision packages (or programmes) that relate inputs (costs) with outputs (benefits), (ii) each one be evaluated through systematic analysis, and (iii) all programmes be ranked in order of performance.

Zero Base Budgeting aims at achieving a state of affairs whereby the whole of the budget needs to be justified in order to (a) combat waste and complacency (b) ensure that the relative tasks and activities remain under constant watch and review alternative stages of action in each sector periodically. The concept of zero base budgeting is as old as the concept of budgeting. Since the first budget of any organisation is always prepared from zero, all the organisations experience this approach at least once. Though, in zero base budgeting the thought is proposed to experience it year after year i.e. every time the budget for the after that period is prepared. This does not mean that efforts made earlier are not taken into consideration at all. What it exactly means is that one necessity-evaluate all activities to find out the stage to which such activity should be funded, i.e. whether it should be eliminated or shall be funded at reduced stage or increased stage or similar stage? It shall be determined through the priorities recognized through top management and through the availability of funds.

ZERO BASE BUDGETING AND TRADITIONAL BUDGETING: A COMPARISON

Zero Base Budgeting is more or less a self-defining term. As we have discussed earlier, in zero base budgeting all expenditures are thoroughly analyzed from zero base, such that the current expenditure stages are justified. In contrast, traditional budgeting usually begins with estimation of current costs. These estimates serve as the starting point to which management will add data corresponding to price changes, estimated inflationary uplifts and planned additions, deletions or alternatives. The assumption is customarily made that current expenditure is justified, such that only the large budgeted increments from current expenditure stages need to be investigated. Failure to investigate current expenditure concerning its necessity and effectiveness will lead to funding of activities for which no increase, or perhaps a decrease in spending is warranted.

Traditional budgeting has not proved to be an appropriate tool for shifting possessions from low to high priority areas. It does not involve the same rigorous approach as zero base budgeting and does not answer the question as to whether we are getting value for the money being spent. Zero Base Budgeting is a decision-oriented approach and focuses on old and new activities and connects short and long range goals through monitoring the achievements of objectives. On the other hand, traditional budgeting is accounting-oriented and focuses on increments and monitors expenditures. The logic behind traditional budgeting techniques stresses on three points:

- Last year’s spending stage is extrapolated into after that year,
- Some growth factor is added on account of inflation; augment in prices of raw material and wages etc.

- Spending stage is further incremented for new projects and programmes.

ZBB attempts to shift the traditional management approach towards a new mode of thinking and operation whereby the managers not only justify the new proposals and the funds required, but also have to justify the ongoing activities and the funds required for them. In other words, in the conventional budgeting no review of ongoing activities is undertaken. It can be shown through the following diagram:

Traditional Budgeting		Zero Base Budgeting
Review &		Review & Justify
Justify	New Programmes	
On-going		On-going Activities
Activities		
Fixed costs	Existing Programmes	Fixed Costs

Therefore ZBB helps managements to evaluate the claims on scarce possessions in conditions of organization's objectives and to create trade-offs in the middle of current operations, development needs and profits, and allocate the financial and other scarce possessions for the attainment of the objectives or goals of the organisation.

GENESIS OF ZERO BASE BUDGETING

The origin of the concept of ZBB can be traced back to the year 1924 when Hilton Young, the noted English budget authority stressed the need for annual re-justification of budget programmes. Later in 1960 the US Defense department introduced the Programme, Planning and Budgeting System (PPBS). It was based on cost-benefit analysis and was very much similar to ZBB. But the final attempt to introduce ZBB was made through the US Department of Agriculture in 1962, when the budget director suggested that each programme be justified from zero and in 1964, this department prepared the budget.

Though, it was Peter Pyhrr who intended its logical framework and implemented it successfully in the private industry in 1969 while working as a staff control manager in Texas Instruments USA. In 1968, Pyhrr reviewed the speech given through Authur F. Burns on the control of government expenditure which advocated that government agencies should start from ground zero, as it were, with each year's budget and present their appropriation in such a manner that all funds can be allocated on the basis of cost- benefit analysis, resulting in substantial cost savings. Therefore Pyhrr formulated this concept in order to reduce staff costs. He developed this system as a tool for planning budgeting and control. He first applied it to research and development divisions of the company. Finding it successful, he extended it to other divisions of Texas Instruments. Based on this experience he published an article which caught the attention of the then Governor of Georgia -Jimmy Carter who invited Pyhrr to apply the approach to the State of Georgia.

ZBB was introduced for the first time in a government system and was adopted for the formulation of the budget for the fiscal year 1973-74. Jimmy Carter was so much, influenced with its success that when he was elected President of the USA, he introduced the concept of ZBB in Federal Budgeting Control Systems and also made it mandatory through the legislation for the year 1979. President Carter claimed that an effective ZBB system will benefit the Federal Government in many ways e.g. it will:

- Focus the budget procedure in a comprehensive analysis of objectives and needs.
- Combine planning and budgeting into a single procedure.
- Cause managers to evaluate in detail the cost-effectiveness of their operations.
- Expand management participation in planning and budgeting at all stages of the federal government.

Following the memo, the office of Management and Budget (OMB) issued Bulletin No. 779 on April 18, 1977 providing budget guidelines and instructions to the agencies on the use of ZBB for the preparation and justification of 1979 budget requests. It stated ZBB as a management procedure that gives for systematic consideration of all programmes and activities in conjunction with the formulation of budget requests and programme planning. The principal objectives of ZBB were to:

- Involve managers at all stages in the budget procedure.
- Justify the resource necessities for existing activities as well as the new activities.
- Focus the justification of the evaluation of discrete programmes or activities of each decision unit.
- Establish, for all managerial stages in an agency, objectives against which accomplishments can be recognized and measured.
- Assess alternative methods of accomplishing the objectives.
- Analyze the probable effects of dissimilar budget amounts or performance stages on the attainment of objectives; and

- To give a credible rationale for re-allocating possessions, especially from old activities to new activities. Though the conversion from conventional budgeting to ZBB did pose some troubles, yet the implementation procedure proceeded smoothly. Therefore in the USA ZBB achieved an unprecedented goal without going for a pilot experiment and the Federal government agencies became the experimental laboratory of ZBB.

Since 1973, in the USA ZBB has become a popular management tool in both public and private organisations. A dozen states, 36 municipalities and 500 corporations have used it with a great degree of success as compared to government agencies.

STEPS/ELEMENTS OF ZERO BASE BUDGETING

ZBB is a four step budgeting procedure which can be applied in a relatively simple way in any organisation. Though, there are a number of circumstances which necessity is fulfilled for a successful implementation of:

- There necessity is a genuine need within the organisation.
- The management environment of an organisation should be objectively assessed.
- A competent management accountant should occupy a senior budgeting position within the organisation.
- A ZBB programme necessity has the unqualified support and involvement of top management.
- ZBB necessity is tailored to the technical necessities of the organisation intending to implement it.
- A budget should be prepared for the organisation.
- The implementation of ZBB programme will be aided through a commitment to post implementation review and maintenance of the programmes.

The vital four steps are:

- Review of organizational structure, and identification of decision units and their objectives.
- Analyzing the decision units, working and evolving documented decision packages.
- Reviewing and ranking the decision packages on the basis of chosen criteria.

- Allocation of organisation possessions to rank decision packages and preparing detailed operating budgets.

Step 1. Decision Units

The first starting step in ZBB is the analytical review of the organizational structure and activities mannered. In every organisation there are meaningful interrelated hierarchical parts which are separated in order to verify the reporting relationships and functional responsibilities. This stage is planned to isolate key decision points in the organization's hierarchy commencing with the lowest stage and progressing to the top.

The identification of the organizational entities (decision units) which will prepare budget requests for the organisation is accomplished through selection through higher stage management. Selections are based on relationship to organisation, special analysis and re-organisation. Other factors are that units are not too low nor too high in the organisation to prevent meaningful review or analysis and the managers of these units create important decisions on the amount of spending and the scope, direction, or quality of work to be performed.

Decision units are recognized through segmenting the organisation into discrete functions, operations or activities for review and analysis. These are the lowest units in the organizational hierarchy which are headed through responsible managers having authority to create decisions on the activities under their control. These should be capable of carrying out dissimilar programmes or activities to achieve an objective.

The identification helps in deciding the stages in the organisation at which budgets should be formulated or ZBB ought to start first. Instead of considering the whole department as decision units, individual sections or performing units of each of these departments should be treated as separate decision unit. The location of decision unit often is a hard exercise. It is imperative that in the identification there should be a complete knowledge about the organizational structure, its management and objectives. Once the decision units have been recognized, each of these necessity be analyzed keeping in view (a) the functions of the department (b) whether any of the tasks are being performed due to some abnormal situations such as expansion, consolidation, whether any of the tasks being performed be reduced or eliminated totally the minimum staffing required to accomplish the normal functions of the decision units.

Step 2. Formulation and Development of Decision Package

Top stage management completes two functions in the zero bases budgeting procedure before decision packages (budget requests) are prepared. It decides as to which stage of management develops the initial budget requests and budget guidance it needs to prepare the requests (decision packages). These two functions illustrate why ZBB is a decision package comprises comprehensive justification for budget estimates of an activity. Such a justification is built up through answering a number of questions. The first question to be answered is in regard to the need for the proposed expenditure as to what specific purpose it is serving. This would necessitate sharpening the objectives of the expenditure so that it could be evaluated through using the relevant evaluative techniques or measures of performance. In case the proposed expenditure is justified in the context of its objectives, a further question may be asked to know if there is a better alternative of incurring expenditure to achieve the specified objectives. To quote from Government of India's letter issued in 1986 on the subject of "Introduction of zero bases budgeting in the Government of India" a decision package is a budget request which should contain the following:

- An account of the functions or activities of the decision unit.
- The goals and objectives of the several functions/activities of the unit.
- Benefits to be derived from financing the activity/project.
- Relevance of the activity/project to the overall objectives of the organisation/ department in the present context.
- The consequences of its non-funding.
- The projected/estimated cost.
- The yearly phasing of the proposed expenditure.
- Alternative ways of performing the same activity or same objective.

As Pyhrr defines it "the decision package is a document that identifies and describes a specific activity in such a manner that management can (a) evaluate it and ranks it against other activities competing for the same or similar limited possessions and (b) decide whether to approve or disapprove it. One of the important characteristics of the decision packages is that it is used through a manager to describe his or her objectives and responsibilities and how best to meet them at several stages of effectiveness. The manager also defines the methods for achieving the objectives. The manager can recommend elimination of some of the activities.

ZBB Decision Package Format

Decision Package	Company		Code Bank	-
Objective of Activity			Dept	
Level of:			Discussion/Section	
Desired Results	Resources Required	Current Year	Budget Year	% age of current
	Personnel No.			
Description of Activity	Wages Salaries Total staff variable Total			
How and when accomplished				
Alternatives to achieve result				
Advantages of retaining activity				
Consequences if activity is eliminated				
Prepared by	Date	Approved by Date		

Step 3. Ranking of decision packages

After the construction of decision packages the after that significant step is to rank the decision packages. Ranking is the procedure of arranging the several service stages (decision packages) and benefits to be gained from the additional funds to be allocated. These are ranked in order of priority or decreasing benefits to the organisation. The procedure allows management to allocate scarce possessions through concentrating on the following three key questions:

- Where to spend the money first?
- How much should be spent in pursuing these goals and objectives?
- What are the consequences of non-implementing those decision packages which are not going to be approved?

The ranking is done on an ordinal scale (i.e. 1st, 2nd and 3rd etc.) in order of priority. Because of the vast numbers involved the ranking procedure takes place at a number of stages depending on the size, geographical dispersion, stages of management, volume of decision packages, unit managers, budget staff or through ranking committee.

__Cut off stage of funding__

Ranking of decision packages in large organisations is more problematic as compared to smaller organisations. In large organisations identifying each discrete activity with many stages of effort could make a number of troubles. If management has to review in detail and rank every decision package with conflicting needs, it may take valuable time and effort of the top management. This problem could be reduced to some extent through:

- Concentrating management review on lower priority discretionary packages around which the funding stages or cut off stages will be determined.
- Limiting the number of consolidation stages through which the packages will be processed.

All packages presented for funding usually would fall into three categories

- Those with higher priority and high probability of funding.
- Those with marginal priority and which may be funded or not funded depending on the possessions accessible; and
- Those with low priority and low probability of funding.

The cut off stage of funding is usually recognized arbitrarily as a percentage of current year budget or actual expenditure stage or in absolute rupee value. It is significant to note that cut off stage has nothing to do with the ultimate allocation of possessions. It is only a means to help the ranking managers to cut down the time and effort needed to review and rank packages.

Ranking Process

Top level review		A			
Senior level consolidation	B,	B_2	B_3	B_4	
- Middle level	c,	c_2	C_3	Q	C_5
Preliminary ranking by managers who developed it	D,	D_2	D_3	D_4	D_5

Top stage review

Each subordinate review stage prepares a ranking sheet to submit to the after that higher review stage. This sheet serves primarily as a summary sheet to identify the order of priority placed on each decision package. Each time a ranking sheet is filled out through the ranking manager who sends it to the after that ranking manager. It serves the following purposes:

- It identifies cumulative funding stage which helps top management to know whether the total budget request has exceeded the total accessible possessions or is still below it.
- It allows top management to decide which package it wants to review in detail.
- It gives a work sheet to top management to create funding decisions in the middle of many rankings readily, adjust the funding stages etc. .

The ZBB can be adopted through any organisation willing to aggressively eliminate its budgetary deficit. But only managers intimately acquainted with the organization culture can create it work effectively. Although the procedure is ideally suited for cost- effective planned growth, mainly managers almost certainly will be initially interested in its enduring cost-reduction characteristics and the capability it gives for responding flexibility to sudden shifts in an operating environment.

INTRODUCTION OF ZERO BASES BUDGETING IN INDIA

The concept of ZBB has been in use in Indian private industry since long. For instance Britannia Industries Ltd. and Union Carbide have been using it since 1977-78 without calling it Zero base budgeting. Though in government context, it is of recent origin. The first application of the system was in the Department of Science and Technology in 1983. In view of the severe resource crunch for the seventh plan, many alternative steps were recommended to the government through the Eighth Finance Commission and the Planning Commission to prune the wasteful public expenditure and inefficiencies in implementation of government programmes.

The Finance Ministry decided to introduce the system of ZBB in all departments of the Union Government in 1986-87, as it was significant to control the government expenditure of the seventh plan which was showing a negative contribution. Unless the situation was remedied, the only alternative was to cut the plan outlay or to resort to more deficits financing than was envisaged in the plan document. Neither alternative was desirable and so the government had launched a massive economy drive. On 10th July 1986, the Ministry of Finance issued circular-cum-budget guidelines to all ministry departments, and State Governments and Public Sector Undertakings, impressing upon them the need to apply ZBB to all schemes and programmes with over Rs. One Crore outlay from the fiscal year 1987-88. For this purpose, a Central monitoring cell was shaped.

The Finance Ministry had recognized around 150 redundant and low priority schemes with the estimated outlays over Rs. 1000 Crore which the Ministry wanted to eliminate. In the middle of the State governments, Maharashtra has been implementing ZBB in 42 departments. The budget for 1987-88 reflected a saving of Rs. 50 crore. Many. redundant and duplicative and low priority schemes have either been eliminated or merged. Likewise Karnataka Government experimented with ZBB in Public Health and Agriculture Sections and also had plans to apply it to all 45 departments. In the middle of the public sector undertakings, Madras Refineries Ltd., HMT, BHEL, BEL, Indian Telephone Industries, Indian Oil, Neyveli Lignite Corp., a few steel plants and nationalised banks have planned to implement ZBB.

IMPLEMENTATION OF ZERO BASE BUDGETING - BENEFITS AND TROUBLES

The implementation of ZBB has sure benefits and some troubles too. Let us now discuss these:

Benefits of Zero Base Budgeting

The major benefits of the use of zero base budgeting can be the following:

- Zero base budgeting examines all existing and new programmes and activities. It also creates the managers analyze their functions, establish priorities and rank them. This exercise helps in identifying inefficient or obsolete functions within the area of responsibility. In this way possessions are allocated from low priority programmes to high priority programmes.
- This system facilitates identification of duplication of efforts in the middle of organizational units. Such inefficient activities are eliminated and some other activities are merged.
- All expenditures, under this system are critically reviewed and justified and all operations/activities are evaluated in greater detail in conditions of their cost- effectiveness and cost-benefits. This requires managers to find alternative ways of performing their activities which may result in more efficient procedures.
- ZBB promotes the tendency to initiate studies and improvements throughout the period of operation as the persons at the helm of affairs know that the procedure would be exercised after that year and their knowledge and training would enhance efficiency and cost-effectiveness.
- ZBB gives for quick budget adjustments throughout the year. If revenue falls short in this procedure, it offers the capability to quickly and rationally modify goals and expectations to correspond to a realistic and affordable plan of operations.
- ZBB ensures greater participation of personnel in formulation and ranking processes. This helps in promoting stage of job satisfaction and therefore resulting in better control and operational efficiency in the organisation.
- Zero base budgeting is a flexible tool that can be applied on a selective basis. It does not have to be applied throughout the whole organisation or even in all the service departments. Keeping in view the limitations of time, money and persons accessible to install, operate and monitor it the management therefore can select priority areas to which zero base budgeting may be applied.

- The benefits of ZBB therefore can be summed up as follows:
- It eliminates redundant activities and those which are being duplicated.
- It identifies low and high priority activities for resource deployment.
- It justifies budget requests on cost-benefit and cost-effectiveness basis.
- It allocates scarce possessions rationally.

- It sharpens and quantifies objectives and formulates alternative methods of operations.
- It promotes involvement of line managers in budget formulation.

Troubles in Implementation

- Management factors: Whenever any cost control technique like zero base budgeting is adopted there is resistance from sure individuals and groups having interest in the organisation. Since goals, objectives and targets are achieved through the actions of responsible people whose behaviour creates the system work or fail, it is essential for the organisation to look at the effects of adoption of new techniques on the people and the effects of people on techniques. This is very significant for the adoption of ZBB as it challenges the past practices, methods, performance, attitudes, habits etc., of the people working in the organisation. As such it becomes very significant for the management to effectively manage its internal organisation before taking any step towards implementation of the zero base budgeting. Therefore effective management of the organisation is the primary requisite in implementation of the programme.
- ZBB is time consuming and is a more complicated procedure than the conventional budgeting. It requires more staff, a great deal of time and effort as compared to conventional budgeting system. For managers at all stages to understand the system thoroughly there is need for proper communication system.
- ZBB involves voluminous paper work. Each decision unit is supposed to prepare decision packages and provide proper justification. In government departments where there are thousands of programmes and activities, the number of decision packages may run into many thousands. This is bound to make handling troubles and confusion.
- There is no standard formula for identifying the minimum stage of funding.
- Usually minimum stage of funding is recognized on arbitrary basis which comes from top management as budget guidelines. But the viability of this procedure is questionable.
- The ranking of decision packages, particularly when the number of such packages is large, makes a big problem. The ranking may become an unwieldy procedure.
- Zero base budgeting decision and the procedure of fixing priorities become a political nightmare. Disagreement may arise on ranking as managers have a tendency to assign a higher priority, to their own projects.

Troubles of ZBB can be summed up as:

- It challenges the past practices, performance, attitudes, of people.
- It requires more time and effort.
- Detailed costs and necessary information for decision packages often are not made accessible.
- It increases paper work to unmanageable proportions.
- Ranking a large number of decision packages becomes an unwieldy procedure.
- Identifying several stages of funding, particularly the minimum stage is a hard task.

PERFORMANCE BUDGETING

PERFORMANCE BUDGETING: CONCEPT AND OBJECTIVES

The financial system of our country throughout the British period was characterized through high degree of centralization, adherence to rigid financial rules and procedures, integration of accounts and audit etc. After independence, attempts have been made to create the financial administration performance-oriented, with a view to bringing about efficiency and economy in the implementation of plans, programmes and activities. Efforts were made to create the budget an efficient tool of plan implementation. The result has been the introduction of the performance budgeting system in the government.

Performance budgeting is usually understood as a system of presentation of public expenditure in conditions of functions, programmes, performance units, viz. activities/ projects, etc., reflecting primarily, the governmental output and its cost. It is essentially a procedure which brings out the total governmental operations through a classification through functions, programmes and activities. Through appropriate narrative statements and workload data that form an integral part of the presentation, it designates the work done, proposed to be done and the cost of carrying these out. The main thrust of performance budgeting has been on providing output-oriented budget information within a long range perspective so that possessions could be allocated more efficiently and effectively. Its emphasis is on accomplishment rather than on the means of accomplishment. The purpose of government expenditure is more significant than the object of expenditure under performance budgeting. Therefore performance budgeting is a programme of action for any given year with specific indicators concerning tasks, the means of achieving them and the cost of achieving them. It tries to describe the physical and financial characteristics of each programme and activity and thereby establish the relationship flanked by output and inputs. Performance budgeting has to operate within the framework of clearly defined objectives which are to be achieved through successful implementation of several programmes and activities undertaken through the concerned agency. Performance budgeting, so, involves the development of more refined management tools, such as work measurement, performance standards, unit costs, etc.

Objectives

Performance budgeting seeks to:

- Correlate the physical and financial characteristics of programmes and activities;
- Improve budget formulation, review and decision-creation at all stages of management in the government machinery;
- Facilitate better appreciation and review through the legislature;
- Create possible more effective performance audit;
- Measure progress towards long-term objectives as envisaged in the plan; and
- Bring annual budgets and developmental plans together through a common language.

COMPONENTS OF PERFORMANCE BUDGET

The performance budgets have sure vital ingredients that need to be constantly kept in view:

- A programme and activity classification that represents the range of work of each organisation;
- A framework of specified objectives for each programme;
- A stipulation of the targets of work or attainment; and
- Appropriate workload factors, productivity and performance ratios that justify financial necessities of each programme.

STEPS IN PERFORMANCE BUDGETING

Four vital steps are involved in the introduction of performance budgeting:

- Establishing a meaningful classification of public expenditure in conditions of functions,
- The establishment, improvement and extension of activity schedules for all measurable activities of the government;
- The establishment of work output, employee utilization, standard or unit costs through objective methods, i.e. Bringing the system of

accounting and financial management into accord with the classification; and

- The creation of related cost and performance recording and reporting system.

The significant requirement for performance budgeting is a programme of action for any given year with specific indications concerning the tasks, the means of achieving them and the costs of achieving them. This is significant even in traditional budgeting procedure. The distinction, though, is that under performance budgeting the organisations are compelled to think of their future activities not merely in conditions of financial plans but in conditions of the results, work assignment and organisational responsibilities. It is normally held that in the context of planning for economic growth, planning is a thinking procedure and budgeting is a doing procedure. Since the physical and financial characteristics go together and the programme structure is expected to be the same, performance budgeting facilitates the functional integration of the thinking and doing procedure.

The formulation of programmes for achieving the organisational goals is an significant task in the budgetary procedure. A programme is a segment of an significant function and represents a homogeneous kind of work. These programmes of work need to be developed for meeting the short-term plans, medium-term plans and long-term plans and involve formulation of schemes, laying down their targets, measuring the financial costs and benefits. The programme has to be assessed in the light of financial and economic factors i.e. ensuring adequate possessions for the programme so chosen and examination of the impact of the proposed outlays on the economy as a whole through cost-benefit analysis. Complex programmes are divided into sub-programmes to facilitate execution in specific areas. Each programme or sub-programme further consists of several activities which are shown in the respective budgets. For instance immunization programme is a programme under the function ‘health’. As each programme has several activities, provision for storage of vaccines could be an activity under the programme.

The real commencing point in the budgetary procedure is allocation of possessions. In the conventional system primary emphasis is laid on the previous stage of allocations and spendings and no emphasis is laid on its performance in conditions of its objectives and the programme of action that it has set out for itself for the after that year. Under performance budgeting the primary agency prepares the budget, submits its necessities as per programme classification. It designates its past activities, their costs, the activities to be taken up throughout the after that year, the results expected and the pattern of assignment of responsibilities. The very basis of the performance budgeting is commitment to attainment and the awareness of accountability. The budget so prepared is reviewed at higher stage and possessions are allocated keeping in view the priorities of the proposal. Some times due to financial constraints possessions may not be accessible in full and a cut has to be imposed. Though, this may be done in full awareness of the implications of the cut on the programme. Under performance budgeting, the programme classification and the rationale behind it indicate a group of choices with their priorities, already made. This minimises the dislocational effect of cuts and ensures a better identification of their impact on programme attainment.

Resource allocation is followed through budget execution. Budget execution necessityensure attainment of objectives and for that the following budgetary and managerial thoughts necessitybe kept in view:

Communication of the grants to the several subordinate agencies well in time

- Ensuring the initiation of action for implementing the schemes provided for in the budget
- Overseeing the regular flow of expenditures
- Prevention of cost Over-runs; and
- Time phased plan for expenditure and work.

The final stage in the performance budgeting procedure is appraisal and evaluation. Under the existing system evaluation of the physical achievements in sure sectors is being undertaken through the Programme Evaluation Organisation. Under performance budgeting, each programme would lend itself to an evaluation through the agency concerned, even before it is undertaken through an outside organisation. The significant characteristic is that evaluation should, as far as possible, follow the completion of a programme and the administration should be enabled to formulate its future course of action in the light of results obtained.

PERFORMANCE BUDGETING SYSTEM IN INDIA

The need for performance budgeting in India was felt ever since India entered into planning era. The then existing budgeting and control system was found inadequate as no input-output relationship could be recognized flanked by financial outlays and physical targets. The first revise concerning the relevance of performance budgeting to our institutional set-up and needs was made through Dean Appleby in 1953. At that stage, though, the system of performance budgeting was still incipient in the federal government and Dean Appleby was not very sure of the outcome of the system. The Estimates Committee of the Lok Sabha, in its 20th report recommended that "... the Performance-cum-Programme System of budgeting would be ideal for a proper appreciation of the schemes and outlays incorporated in the budget, especially in the case of large scale developmental activities. The Performance

Budgeting should be the goal which should be reached slowly and through progressive stages without any serious budgeting dislocation." The recommendation was primarily made to strengthen the parliamentary control over expenditure.

The Estimates Committee raised the issue again in their 73rd report in 1960 and suggested that the recommendation concerning performance budgeting be implemented at the earliest possible. These recommendations brought results. In 1961, the Union Finance Ministry accepted the recommendations of the 73rd report of the Estimates Committee and issued instructions exhorting the public enterprises to adopt performance budgeting. Though due to operational troubles, no undertaking implemented the instructions.

In 1964 performance budgeting again became a focus of attention when the Planning Commission held that "the stage has reached when appropriate methods of Performance Budgeting should be evolved, so that these become an integral part of the machinery for planning and supervision over plan fulfillment." As a part of the implementation of this suggestion, the planning commission shaped a Performance Budgeting unit in the Committee on Plan Projects in 1965. In order to identify the benefits this unit mannered a number of studies which provided the database for Administrative Reforms Commission. When Administrative Reforms Commission was set up, a working group on performance budgeting was recognized through the Commission.

The working group recommended the introduction of performance budgeting in India in the developmental departments both at the Centre and in the States, in a phased manner. The Administrative Reforms Commission further recommended that the introduction of Performance budgeting should be initiated with the budget of 1969-70 and completed through 1970-71. In view of this, the Union Finance Ministry submitted a document recognized as "Performance Budgets of Selected Organisations 1968-69" to the Lok Sabha in April 1968. The Government of India, on the recommendation of ARC (Administrative Reforms Commission) issued guidelines for the adoption of Performance Budgeting in all ministries, departments and State Governments w.e.f. 1973-74. American budget experts were also invited to advise the Government of India on the introduction of performance budgeting.

PERFORMANCE BUDGETING SYSTEM — A CRITICAL EVALUATION

The government accepted performance budgeting and initiated the procedure of change, slowly and cautiously, approximately two decades ago. The system has since been introduced in all development departments at the centre. Some of the states like Maharashtra, Punjab, Rajasthan, Tamil Nadu and Uttar Pradesh have introduced performance budgeting in a large number of departments. The progress has, though, been very slow in mainly of them, it is, so, necessary to take stock of the gains and limitations relating to performance budgeting. This shall help in consolidating gains and tackling troubles and creation performance budget an effective tool of internal financial management at all stages of government.

Performance Budgeting improves legislative review through presenting a comprehensive view of the several departments and agencies of the government. In fact this system ensures all the advantages that are likely to accrue from an organic integration of the procedure of planning and budgeting. Performance Budgeting helps to improve public relations through providing clearer information for a rational public appraisal of responsible government. The welfare content of a progressive budget on an activity basis would strengthen the democratic procedure and evoke meaningful participation of the citizens in the implementation of the tasks set out in the budget.

In any organisation decision-creation with regard to allocation of possessions, determining order of priorities and the structure of responsibilities, is dependent upon the efficiency of the system of information and communication. Only performance budgeting accompanied through decentralized accounting and systematic reporting could give such informational support. Functional classification facilitates integration of the procedure of planning, programming and budgeting. If annual budget is essentially a part of the long-term development plan relating to the public sector, the traditional budget does not facilitate the interweaving of the physical and financial characteristics. The advantages of performance budgeting in such a situation is that it brings the financial and physical characteristics together right from the beginning of the proposal to the final stage of the scheme.

In brief, performance budgeting gives for more effective controls, creates legislative control more meaningful, helps to gear the procedure of decentralization of authority in conventionality with responsibility and improves public relations. Having measured the dissimilar characteristics of the technique it shall be in the fitness of things to briefly enlist some of its limitations as well. Significant in the middle of these are as under:

- The very basis of performance budgeting is classification of governmental work into functions, programmes and activities. But in practice it may not be possible to have such well-organized categories.

- The programme and activity classifications developed are sometimes too broad to reveal the important activities of the department to serve as a basis for budgetary decisions and management.
- This technique focuses on quantitative than a qualitative evaluation.
- The procedure of allocation of cost estimates over programme elements is hard and often these estimates may not be as meaningful as they should be.
- Performance budget aids but does not solve the greatest problem in budget decision creation, viz., the comparative evaluation of projects, functions or activities, unless it is supported through cost-benefit analysis which itself is far from perfect especially when the indirect and intangible costs and utilities are involved in a big way.

PUBLIC EXPENDITURE: THEORIES AND GROWTH

DETERMINANTS OF PUBLIC EXPENDITURE

Several theories have been formulated throughout the last three decades to explain dissimilar characteristics of public expenditure. In spite of all these attempts, no comprehensive theory of public expenditure has been developed. Let us now discuss some of the significant theories which seek to explain the factors that determine rising public expenditure.

Marginal Utility Approach

This is one of the significant theories developed in the 1920s which suggested an economic approach to determine the composition of expenditure and budgeting. According to this theory, the government spends its limited income on alternative services in such a way that the marginal benefit is the same on all items. Just as an individual, in order to satisfy his/her wants, spends in a manner to achieve a sure balance in the middle of dissimilar kinds of expenditure which would ensure, some marginal return of satisfaction from all of these. According to Pigou, "Expenditure should be so distributed flanked by battleships and poor relief in such wise that the last shilling devoted to each of them yields the same real return." The same principle has been restated through Dalton therefore "Public expenditure should be accepted just so far that the marginal social advantages of expenditure in all directions are equal and just balance the marginal social disadvantages of all methods of raising additional public income".

Though the principle of maximum social advantage is quite attractive in theory, there are practical troubles in creation it operational. Firstly, it is not easy to quantitatively measure the benefits flowing from diverse items of public expenditure for instance, expenditure incurred on defense and social security. Secondly, this theory cannot be subjected to a test. Evaluation of activities of the government is hard due to the vast array of services and goals of the government and absence of an acceptable measure. Thirdly, it is not only the stage of present satisfactions of the 'Community' that a government will be concerned with. The future interests of the community are also significant. Fourthly, what the community can afford also depends on how the money is raised and how it is spent. Expenditure on unnecessary wars or departments of the government may result in social disadvantages. Expenditure on sustaining loss-creation public enterprises with social service content may, on the other hand, be easily justified. This principle is therefore, at best, applicable to the use or sharing of a fixed sum rather than as a standard for determining the total size of public expenditure.

Public Goods Approach

Public goods are those for which no private mechanism exists for providing them and which are consumed in equal amounts through all. People who have not paid for them cannot be excluded from their enjoyment, e.g. public parks or security. Public goods usually correspond to all goods and services provided through government and contain a wide diversity of goods and services. The demand for such public goods becomes a significant element in the determination of public expenditure.

Public Choice

The recognition of the importance of the political processes in revealing public preferences has, in due course, contributed to the growth of "public choice" theories. Anthony Downs offered useful analysis of these political processes. Downs' theory, which was based primarily on the US systems, provided a general framework for explanation of public expenditure. In democratic societies, it is held; governments determine revenues and expenditure to maximize their chances for winning the election. The budgeted expenditure is determined not with reference to overall spending and taxation but through a series of separate policy decisions based on estimates of gains and losses of votes. According to Downs, government will give what voters want and not necessarily what is beneficial. Therefore the central reality for governments is the citizen's vote and not his welfare. In order to fulfill voters' demands, promises made at election time, their aspirations for projects or services, the expenditure has to expand creation for larger government, larger bureaucracies, better budgets and more troubles in trying to find possessions for financing the budgeted expenditure.

Positive Approaches

The earliest theory advanced is that of Adolph Wagner in 1876 which came to be recognized as “Wagner’s law”. He propounded the “Law of rising expansion of public and particularly state activities” which is referred to as the “law of rising expansion of fiscal necessities”. The law suggests that the share of the public sector in the economy will rise as economic growth proceeds, owing to the intensification of existing activities and extension of new activities. According to Wagner, social progress has led to rising state activity with resultant augment in public expenditure. He predicted an augment in the ratio of government expenditure to national income as per capita income rises. It is the result of rising administrative and protective actions of government in response to more complex legal and economic relations, increased urbanization, and rising cultural and welfare expenditures. Another cause is the decentralization of administration and the augment in the expenditure of local bodies.

According to Musgrave, though, it is not fruitful to seek an explanation for the total expenditure. Tests accepted out through several researchers have shown that the augment in expenditures is far more complex than is apparent from the tests accepted out on empirical data. So, according to Musgrave, it may be far more rewarding to adopt a desegregated approach (an approach which divides the revise of expenditures of government) through a revise of expenditures of government on capital formation, consumption and transfer payments.

Displacement Effect Hypothesis of Peacock and Wiseman

Peacock and Wiseman based on a revise entitled “The Growth of Public Expenditure in the UK, 1961”, provided an explanation to fluctuations in public expenditure over time. The hypothesis put forward is that public expenditure grows due to growth in revenue. Throughout settled times, people can be expected to develop notions of acceptable rates of taxation. This can be recognized as the tolerable stage of taxation and this stage cannot be high. With real economic growth, the more or less stable stage of taxation will produce rising amounts of revenues as well as expenditure. This, though, does not explain the relative rising growth in public expenditure.

Large scale social disturbances, like wars, influx of refugees change the tolerance limit of people to the burden of taxation which arises as a result of increased spending. The result is described a “displacement effect” which shifts expenditures and revenues to new higher stages. So a displacement effect is created when the earlier lower tax and expenditure stages are displaced through new and higher budgetary stages. Even after the event is over, new stages of tax tolerance change and the society feels capable of carrying a heavier tax burden. The stage of public expenditure does not return to the low stage it was before the event.

IMPACT OF PUBLIC EXPENDITURE

According to Dalton "increased public expenditure in several of these directions is desirable in order to bring about that sharing of the community's possessions flanked by dissimilar uses, which will provide the best results, balancing without bias the present and future".

Changes in national priorities, from time to time, will be reflected in the pattern of public expenditure. Again, resource allocation has to take into account the balance flanked by present needs and future necessities. Separately from imparting a sense of fairness as flanked by generations, projects with long gestation periods can be undertaken only through the state. Hence allocation has to keep in view the fact that market economy cannot always take care of social needs. These can be taken care of only through the state.

Production

The roles of private and the public sectors are complementary. The public sector gives the infrastructure, transport and communications, power, education and public health programmes. In the absence of goods and services provided through the government sector, private sector can hardly create any meaningful contribution towards production and development; According to Dalton, other things being equal, taxation should not adversely affect production and public expenditure should augment it as much as possible. Public expenditure can affect (i) the skill to work, save and invest, (ii) the desire to work, save and invest, and (iii) allocation of possessions as flanked by dissimilar uses. Public expenditure can influence these factors either favorably or unfavorably.

The economies of developing countries cannot create important progress unless they concentrate on development of investment goods sector. This may not result in production in the immediate future, as in education and health programmes, infrastructural projects and projects with long gestation periods. This would, though, certainly build up growth potential in the economy, and help take the economy to a self-generating stage.

Sharing

In Dalton's words, "other things being equal, that system of public expenditure is best, which has the strongest tendency to reduce the inequality of incomes?" A system of grants and subsidies is equitable in the measure in which it is progressive. This leads to maximum social benefit. An approximation to this principle would be provided through a system of grants which would bring all incomes below a sure stage to that stage (say, above the poverty line), without adding anything to incomes above that stage. A public sharing system which creates accessible essential commodities at subsidized prices to the poor, will also achieve the same result. Free provision of services to all members of the society e.g., free health service or free education, "narrows the area of inequality". Social security measures and social insurance schemes, which are helped partly or wholly from public funds, e.g. old age pensions, sickness and maternity benefits, unemployment relief, industrial injury compensation, widow's pension etc., improve sharing through reducing inequality of incomes.

Economic Stabilization

Business activity in an economy is usually characterized through fluctuations of a cyclical nature. A boom in the economy may burst and lead to a depression. While throughout boom, prices rise beyond the reach of common person, spelling misery. Throughout depression, employment and production stages fall drastically causing colossal damage. Throughout depression, when employment, production and national income start declining, government can undertake compensatory spending. This may imply heavy public works programmes so that employment and incomes may pick up leading to economic recovery. Throughout boom, public expenditure should be strictly curtailed, leading to surplus budgets. Throughout depression, public expenditure policy would lead to heavy outlays on public works; expenditure would therefore be in excess of revenues, leading to deficit budgets. Therefore public expenditure, if properly planned and conscientiously undertaken, will have the favorable effect of raising employment, production and national income, after pulling the economy oat of depression and therefore bringing about greater economic stability.

GROWTH OF PUBLIC EXPENDITURE IN INDIA

The total expenditure of the Central government has grown from Rs. 529 crore in 1950-51 to Rs. 1,19,087 crore in 1992-93 (budget estimates) (225 times). Of this revenue expenditure grew even faster. It went up from 347 crore in 1950-51 to Rs. 89,570 crore in 1992-93 (B.E.) (258 times). But capital expenditure grew at a slower rate. It increased from Rs. 183 crore in 1950-51 to Rs. 29,517 crore (161 times). It is, though, clear that the total expenditure of the Central government has grown at a much faster rate than the growth rate in national income which went up from Rs. 8,938 crore in 1950-51 to Rs. 4,25,672 crore (estimated) in 1991-92 (48 times). One can say that the total expenditure has been rising at a rate about 5 times higher than the growth rate of national income Gross National' Product.

The trends of the Central government expenditure seem to support two of the mainly widely discussed approaches to the behaviour of public expenditure. First, there has been an augment in public expenditure that conforms to Wagner's law of rising state activity. This is obviously the result of the planned economic development undertaken in India since 1950-51. Second, there have been many discontinuities in the trend, suggesting the pressure of Peacock-Wiseman "displacement effect". As already stated, this effect hypothesizes that government spending rises through discrete stages in response to the periodic occurrence of "social upheavals". Some of the discontinuities in Indian government spending, though, can be attributed to events that may not qualify as "social upheavals". It has been shown that the "displacement effect" was a factor responsible for augment in spending throughout and after the Indochinese hostilities of 1962. Other factors are: rehabilitation of displaced persons from Pakistan, oil price hike in 1973 and the inflation that followed, and Indo-Pak war in 1971.

Another salient characteristic of the growth of government expenditure is the augment in the relative share of revenue expenditure in the total expenditure. This share was 65.5 per cent in 1950-51. When planning got underway and gathered momentum in the first two decades, revenue expenditure always stood at less than 50 per cent of the total outlay of the Central government. The balance, over 50 per cent, was accounted for through capital expenditure. Since the seventies, though, the rate of growth of revenue expenditure has far exceeded that of capital expenditure. In the eighties, revenue expenditure has increased at twice the rate of augment in capital expenditure.

Recent Trends

Throughout the two years (1991-92 & 1992-93) (BE) the pace and direction of expenditure have changed radically. The revenue expenditure in 1991-92 increased through 13.8 per cent over that in 1990-91 whereas capital expenditure actually declined through seven per cent. In 1992-93 (BE), while the revenue expenditure increased through only seven per cent (down from 13.8 per cent augment in 1991-92), there was a standstill in respect of the capital expenditure. There are two reasons responsible for the downward trend in the rate of augment in government expenditure. Firstly, the fiscal crisis faced through the country beginning with the year 1990-91, deepened in 1991-92. The government initiated corrective measures to restore fiscal discipline in the economy. Some of the key elements in this structural adjustment were containment of non-plan expenditure including defense expenditure and subsidies. Secondly, the economic philosophy of the government has undergone a revolutionary change. The investment programme of the government is no longer aimed at rising investment in public sector enterprises. With the liberalization of the economy — changes in industrial and trade policy, financial sector reforms etc., are all aimed at less government intervention rather than more. Hence, the relative decline in government expenditure. This is every cause to consider that this trend will continue in the foreseeable future.

CLASSIFICATION OF GOVERNMENT EXPENDITURE

CLASSIFICATION OF GOVERNMENT EXPENDITURE

Since the latter part of the 19th century and earlier part of the 20th century, mainly of the capitalistic and socialistic countries switched over to the concept of welfare state. Throughout this period, mainly governments of independent countries concentrated their energy on economic development. To achieve speedy economic development, governments had stepped up their expenditures. Nature of Government Expenditure: Public expenditure is incurred in the form of purchases of goods and services, transfer payments and lending. Purchase of goods and services is planned to carry out governmental activities through the direct utilization of economic possessions for instance, purchase of articles from the market right from paper clips to military aircraft. Transfer payments and lending are planned to give enterprises and households with purchasing power to enable them to buy goods and services in the market. In several developed countries, transfer payments for social welfare constitute a sizeable portion of government budgets. In developing countries, some of the functions of transfer payments are performed through subsidies to consumers in the form of below cost sales through state enterprises. Examples of such subsidies are supply of bread, food grains, cooking oils, sugar and tea to public below the normal cost. '

Classification of Expenditure: Government expenditure can be broadly classified into four categories: (i) Functional Classification or Budget Classification (ii) Economic Classification (iii) Cross Classification and (iv) Accounting Classification. As already mentioned, each classification of expenditure in government serves one objective or other i.e. financial control, economic growth, price stability etc.

Functional or Budget Classification

In India, the classification of accounts was structured so as to correspond to the organisation in which the transaction occurred and within the organisation to the inputs on which expenditure was incurred. For instance, construction of a hospital would be classified and displayed in accounts as "public 'works expenditure" and not as expenditure on a programme like "Medical Relief" under social services. The classification indicated the nature of expenditure but not its purpose. It did not enable identification of expenditure with functions, programmes, activities and projects. It lacked management approach in accounting in as much as it did not give the facility for monitoring and analysis of expenditure on functions, programmes, activities and projects. The Government of India introduced in April, 1974 a revised accounting structure, which attempts to serve the purposes of management as well as the requirement of financial control and accountability. Under this scheme, a five-tier classification has been adopted i.e. sectoral, major head, minor head, subhead, and detailed heads of account. Sectoral classification has grouped the functions of government into three sectors, namely. General Services, Social and Community services and Economic services.

In the new scheme of accounts, a major head is assigned to each function and minor head is allotted to each programme. Undereach minor head, there would be subheads assigned to activities/schemes/organisations sheltered through the programme. Under the new system, the object classification has been retained and placed at the last tier. It is meant to give item-wise control over expenditure and ensure financial control and accountability. Functional classification recognized adequate links flanked by budget and account heads and the plan heads of development. This has facilitated obtaining information of progressive expenditure on plan programmes and projects. The principle adopted in the new accounting classification is that all expenditures on a function, programme or activity should be recorded under the appropriate major, minor or subhead. Functional classification has provided the necessary facility for monitoring and analysis of expenditure on functions, programmes and activities to aid the management function.

Economic Classification

Economic classification refers to the possessions allocated through government to several economic activities. It involves arranging the public expenditures and receipts through important economic categories, distinguishing current expenditure from capital outlays, spending for goods and services from transfers to individuals and institutions, tax receipts through type from other receipts and from borrowing and inter-governmental loans, grants etc. This classification brings out such significant aggregates as public expenditure of the consumption type, public investment and the draft of public authorities on public savings for financing the development oulays in the public sector. In short, this classification analyses the total governmental transactions and records government's influence on each sector of the economy.

Cross Classification or Economic-cum-Functional Classification

Cross classification gives the break-up of government expenditure not only through economic categories but also through functional heads. For instance, expenditure on medical facilities (a functional head) is split flanked by economic categories such as current expenditure, capital expenditure and several kinds of transfers and loans. Conversely, cross classification shows how expenditure on a scrupulous economic category, say capital formation, is divided according to dissimilar public activities like education, labour welfare, family planning etc.

Under a scheme of cross classification, functional classification of expenditure can be analyzed according to its economic character and economic classification of expenditure can be analyzed according to the functions performed through it. The two kinds of classification so supplement each other and provide a clear picture of the total transactions of government.

Accounting Classification

Accounting classification of government expenditure can be analyzed under (i) Revenue and Capital (ii) Developmental and Non- Developmental and (iii) Plan and Non-Plan. Each classification of expenditure serves one objective or other of the government. For instance, Revenue and Capital expenditure classification designates how much government expenditure results in creation of assets in the economy and how much expenditure is unproductive. Again, developmental and non-developmental classification designates how much government expenditure is spent on social and community services and economic services as against general services. Likewise, the Plan and Non-Plan expenditure classification helps the Planning Commission and Finance Commission in determining the pattern of central assistance on plan schemes to state governments, and union territories. Therefore, each classification of government expenditure serves one objective or other in government.

REVENUE AND CAPITAL EXPENDITURE

The variation flanked by Revenue and Capital expenditure is the variation flanked by expenditures that result in the creation of new assets and those which do not. Goods and services consumed within the accounting period may be incorporated in the current expenditure; alternatively, the allocation may be based whether an expenditure is “revenue producing or not”. The main purpose of the capital account is to show the gross and net capital formation in the public sector throughout the accounting period (i.e. say from 1st April to 31st March).

Under the Indian Constitution, budget has to distinguish expenditure on Revenue account from other expenditures. Government budget comprises Revenue Budget and Capital Budget. Revenue budget consists of revenue receipts of government (tax- revenues and other revenues) and the expenditure met from these revenues. Tax revenues comprise proceeds of taxes and other duties levied through the Union. Revenue expenditure is for the normal running of government departments and several services, interest charges on debt incurred through government etc. Broadly speaking, expenditure which does not result in creation of assets is treated as ‘Revenue expenditure’. All grants given to state governments and other parties are also treated as revenue expenditure.

Capital budget consists of capital receipts and payments. The main items of capital receipts are loans raised through government from public which are described market loans, borrowings from Reserve Bank of India and other parties through sale of Treasury Bills, loans received from foreign governments and loans granted through Central government to state and union territory governments and other parties.

A Capital expenditure may be defined as any expenditure other than operating expenditure, the benefits of which extend over a period of time exceeding one year. The main feature of capital expenditure is that at least a major portion of the expenditure is made at one point in time and the benefits are realized at dissimilar points in time in the ensuing years. In other words, Capital expenditure is the expenditure which is planned for creating concrete assets of a material character in the economy. Examples of Capital expenditure are the acquisition of assets like land, structures machinery, equipment and also investment in shares and loans and advances granted through Central government to state and union territory governments, government companies etc.

With the advent of planning in India in 1951, Capital expenditure incurred on plan account has assumed an enormous significance. It has also its economic effects depending on whether the projects financed through capital expenditure are quick yielding or long yielding in economic benefits. Also, it has its impact on the revenue budgets of the Centre. In brief, the variation flanked by revenue and capital expenditure is the variation flanked by expenditures which result in creation of new assets and those which do not. Revenue expenditure is for the normal running of government departments and several services, interest charges etc. On the other hand, capital expenditure or at least some portion of it results in creation of assets in the economy.

DEVELOPMENTAL AND NON-DEVELOPMENTAL EXPENDITURE

Government expenditure can be classified into “Developmental” and “Non- Developmental” expenditure. Developmental expenditure comprises expenditure incurred on education medical care public health and family planning labour and employment, agriculture, cooperation, irrigation, transport and communication and other miscellaneous services. Expenditure incurred on these items both on Revenue and Capital accounts is also treated as development expenditure. Non-Developmental expenditure, on the other hand, comprises expenditure incurred on items like defense, collection of taxes and duties, administrative services, interest on debt and other services, stationery and printing and other expenditure on general services.

Developmental expenditure is an accounting concept that has grown in conjunction with economic plans. It constitutes the main target of the plan. It enables planners to specify a measurable stage of attainment that the economy may attain within the planning period. Through providing a target for developmental expenditure in the plans, the economic aspirations of citizens are focused. Sure classes of public expenditure are treated as developmental through fiat and they are treated as component of plan expenditure or government contribution to economic growth.

Developmental expenditure is said to be directly related to the promotion of backward economy; non-developmental expenditure does not help development. But in reality, capital expenditure on administration, rehabilitation, relief does help directly or indirectly the economic development of the country. Hence, it is hard to follow a rigid distinction flanked by developmental and non-developmental expenditure, though it is customary to create such a distinction for broad analytical purposes.

It is well-recognized that no developmental expenditure is “developmental” indefinitely or advantageous to the economy, irrespective of the amounts being spent through government departments. To the best of government’s knowledge, each item of expenditure (i.e. Developmental and Non-Developmental) necessity contribute equally on the margin to economic welfare. Too much emphasis on “Developmental” and “Plan expenditure” will ultimately lead to a reduction in “Non-Developmental” expenditure and thereby indirectly affects the growth of the economy. In brief, Developmental expenditure leads to economic growth whereas Non-Developmental expenditure does not. Developmental expenditure comprises the expenditure incurred on social and community services and economic services. Non-Developmental expenditure comprises the expenditure incurred on general services. The distinction flanked by “Developmental” and “Non-Developmental” expenditure beyond a sure point, gives a distorted picture of the whole government expenditure, as Non-Developmental expenditure also contributes to economic growth indirectly and as such it is not totally unproductive. For instance expenditure on defense, though it is non-developmental, is very much required for establishing defense preparedness of the country which cannot be weakened.

PLAN AND NON-PLAN EXPENDITURE

Government expenditure can also be classified into “Plan” and “Non-Plan” expenditure. Plan expenditure refers to the expenditure incurred through the Central Government on Programmes/Projects, which are recommended through the Planning Commission. Non-Plan expenditure, on the contrary, is a generic term used to cover all expenditure of government, not incorporated in the plan.

Non-Plan expenditure consists of several items of expenditure, which are obligatory in nature and also essential obligations of a state. Items of expenditure, such as interest payments, pensioner charges, statutory transfer to states come under the obligatory nature. Defense, internal security are essential obligations of a state. Any neglect of these activities can lead to collapse of government. Besides, there are special responsibilities of the Central Government like external affairs, currency and mint, cooperation with other countries and the expenditure incurred in this connection are treated as “non-plan” expenditure. Of all the major items of Non-plan expenditure of the Central Government, interest payments, defense, subsidies take the lion’s share of expenditure.

The distinction flanked by ‘plan expenditure’ and non-plan expenditure’ is purely an administrative classification and is in no way related to economic or national accounting principles. For instance, in several cases ‘plan expenditure’ becomes non-plan expenditure, after the plan is over. Again, an item of plan expenditure throughout a scrupulous five year plan becomes “non-plan” in the following plan, if its responsibility is shifted on to the state governments, as in the case of centrally sponsored and central sector schemes or if the expenditure spills over from one plan to the after that or the expenditure is agreed to be incurred outside the plan outlay of the state governments approved through the Planning Commission.

The classification of expenditure flanked by “Plan” and “Non-Plan”, “Developmental” and “Non-Developmental” of sure schemes/projects in government gives a distorted view of government’s classification of expenditure. After all, the test of public expenditure is the amount of satisfaction it gives to the public through the quantity or quality of services it creates possible. But classification like ‘Developmental’ and ‘Non-Developmental’ expenditure may ignore the point, unless a sense of proportion is maintained. For instance, maintenance expenditure of a structure is likely to suffer, whereas a plan scheme, even if it is not significant, acquires a priority and urgency, out of its proportion, because it is a ‘plan’ item of expenditure. Again, it is possible to make posts under plan schemes, even if a ban exists on creation of posts. Therefore, the classification of expenditure into ‘Plan’ and ‘Non-Plan’, sometimes, endows sure schemes with more than necessary legitimacy and thereby acts to distort one’s view of public expenditure.

AN EVALUATION OF THE SYSTEM OF CLASSIFICATION OF EXPENDITURE

The classification of government expenditure is done mainly to achieve the objectives of government i.e. financial control, estimation of revenues and expenditures of government, allocation of funds to the several sectors of the economy, economic growth etc. In order to achieve these objectives, public expenditure has been classified into four categories, viz., Functional classification, Accounting classification, Economic classification, and Cross classification. Accounting classification classifies government expenditure into “Revenue” and “Capital”, ‘Developmental” and “Non- Developmental”, “Plan” and “Non-Plan” expenditure.

Developmental expenditure is said to be directly related to the promotion of the backward economy, whereas non-developmental expenditure does not. Though, in actual practice, non-developmental expenditure in the form of the capital outlay on rehabilitation, administration and relief does contribute directly or indirectly to the economic development of the country.

The classification of government expenditure into “Plan” and “Non-Plan” is purely an administrative classification and is not related to economic or national accounting principles. Also, the “Plan” and “Non-Plan” do not correspond exactly to “Developmental” and “Non-developmental” categories respectively because we find both these kinds of expenditure under “Plan” and “Non-plan” heads. For instance, the expenditure related to new projects/programmes becomes ‘Plan’ expenditure throughout the period of a five year plan. If the projects/programmes are completed within the five year plan period, then their maintenance will be brought under ‘non-plan’ expenditure, throughout the after that plan period. Again, the ‘plan’ expenditure, throughout a scrupulous five year plan, becomes ‘non-plan’ in the following plan, if the responsibility is shifted on to the state governments, as in the case of centrally sponsored and central sector schemes. Therefore, they classifying expenditure into “Plan” and “Non-Plan”, undue influence is given to ‘plan’ expenditure at the expense of non-plan in government, even though non-plan expenditure also comprises capital expenditure and contributes to the economic development of the country. Though, this classification is found useful through the Planning Commission and Finance Commission for determining the central assistance to states for plan schemes from time to time.

The classification of expenditure into “Developmental” and “Non-Developmental” is also not based on any rational principle. Developmental expenditure is said to be directly related to the economic growth of the country, whereas non-developmental expenditure does not. In practice, non-developmental expenditure, in the form of capital outlay on rehabilitation, administration and relief, does help directly or indirectly in the economic development of the country. Hence, it is hard to follow a rigid distinction flanked by “Developmental” and “Non-Developmental” expenditure.

But it is customary to create such a distinction for broad analytical purpose. The classification of government expenditure into “Plan” and “Non-Plan”, “Developmental” and “Non-Developmental” gives a distorted picture of the whole classification pattern of government expenditure, because Developmental and Non- Developmental heads are also part of “Non-Plan” expenditure. After all, the test of public expenditure is the amount of satisfaction it gives to the public through the quantity or quality of the services it creates possible. But classifications like the “Developmental” and “Non-Developmental” may ignore this point, unless a sense of proportion is maintained. Though, all the three classifications, viz., Accounting, Economic and Cross classification of government expenditure are essential to determine the allocation of expenditure to several sectors, capital formation, employment opportunities, price stability, economic growth and also for ensuring financial control through Parliament and through government within the departments.

REVIEW QUESTIONS

- Discuss the troubles and benefits in implementation of zero base budgeting system.
- Discuss the performance budgeting system in India.
- Explain how public expenditure policies and measures affect dissimilar characteristics of the economy.
- Explain the meaning of Government expenditure. Distinguish flanked by 'revenue' and 'capital' expenditure.
- Explain the significance of Economic and Cross Classification of government expenditure.

CHAPTER 4

RESOURCE MOBILIZATION

STRUCTURE

- Learning objectives
- Public debt management and role of reserve bank of India
- Deficit financing
- Sources of revenue: tax and non-tax
- Review questions

LEARNING OBJECTIVES

After learning this unit, you should be able to:

- State the meaning and causes of public debt.
- Explain the meaning of deficit financing.
- State the concepts and classification of tax revenue.
- Explain trends in resource mobilization over the years...

PUBLIC DEBT MANAGEMENT AND ROLE OF RESERVE BANK OF INDIA

PUBLIC DEBT — CONCEPT AND CAUSES

Modern fiscal policy endorses unbalanced government budgets for purposes of stimulating economic growth and stabilizing economy, its application leading to a rising public debt. Growth of public debt has been quite substantial in approximately all developing economies in recent years. Public debt in simple words means debt incurred through the government in mobilizing sayings of the people in the form of loans, which are to be repaid at a future date with interest. Public debt can be both internal as well as external. According to Richard Musgrave and Peggy Musgrave, “(Public) borrowing involves a withdrawal made in return for the government’s promise to repay at a future date and to pay interest at the interim”.

The concept of public borrowing as such was condemned earlier through classical economists like Hume and Adam Smith who measured that it would compel the government to tax the public and hence lead to disequilibrium in the economic system. Later the Great Depression of 1929 brought about a marked change in economic thinking of which J.M. Keynes was the pioneer. It was felt that public debt would raise the national income, lead to effective demand in the economy, augment the employment and output, hence it was after the second world war that public borrowings came to occupy a prominent place in the budgets of governments.

Having discussed the concept of public debt, now let us highlight the causes for public borrowing.

- A considerable portion of the public debt is attributable to the sharp increases in government outlays in public sector projects. Structure up the economic infrastructure like railways, roads, bridges, power plants etc. that give the base for economic development, requires vast investments which the government cannot finance just through taxation.
- Another cause for the growth in public debt is due to both the Central and state governments lending important amounts of capital funds to the private sector for investment in planned development projects.
- Public borrowing is resorted to for meeting temporary as well as long-term deficits. It is required to meet the current deficits in budget when the revenues are insufficient to meet the expenditure. Also in times of war, or economic crisis, or other unexpected emergencies, the augment in governmental activities result in rising expenditure that create the government resort to public borrowing.

In recent years, factors-like augment in prices, enlargement of administrative services, rising expenditure on defense, wages and dearness allowances etc., have also contributed to augment in public debt.

CLASSIFICATION OF PUBLIC DEBT

As said earlier, one method through which a public authority may obtain income is through borrowing. The proceeds or whatever is composed from such borrowing form part of public receipts. On the other hand the payment of interest on and the repayment of the principal of the public debts therefore created form part of public expenditure. Public debt can be classified in several ways. Let us now discuss some significant classifications.

Reproductive and Unproductive Debt

A distinction is, often, drawn flanked by 'reproductive debt' and dead weight debt or unproductive debt. The former is a debt which is fully sheltered or balanced through the possession of assets of equal value. These debts are incurred usually for the construction of such capital assets which yield revenue to the government. In case any debt is incurred to meet expenditure on irrigation, railways etc., the income derived from the creation of such assets can be used to repay the debt. With regard to reproductive debt, the interest and sinking fund on it (about which we will discuss later) is normally paid out of income derived through the public authority from the ownership of its property or the conduct of its enterprises. And here it is a good working rule that the debt should be repaid within the physical lifetime of the corresponding asset. Unproductive or dead weight debt is that debt which is incurred to cover any budgetary deficits or for such purposes as do not yield any income to the government in times of war for instance. The interest and sinking fund, if any, on this kind of debt necessity be obtained from some other source of public income, usually from taxation and, since there is no corresponding asset created, there is no rule concerning the period of repayment. -

Voluntary and Compulsory Debt

Public debts are incurred through public loans. There are two kinds of loans — voluntary and compulsory. Voluntary loans are those concerning which people are free to subscribe to government's securities whenever they are floated. The chief advantage of a voluntary load, as compared with taxation is, that, in the case of former, people are free, according to their circumstances and inclination, to subscribe as much or as little as they please. Compulsory loan is a rarity in modern public finance, though, in emergencies like war, famine etc., government enforces borrowing through legal compulsion to secure required amount of funds. This is also resorted to at times to curb inflationary tendencies in the economy. With this purpose in view only the Government of India introduced the 'Compulsory Deposit Scheme' in 1971.

Internal and External Debt

Public debt may be internal or external. It is internal if subscribed through persons or institutions inside the country. An internal loan only involves transfers of wealth within the borrowing community which in this case is the same as the lending community. In case of external loan, it involves, firstly, a transfer of wealth from the lending to the borrowing community, when the loan is raised and secondly, a transfer in the reverse direction, when the interest is paid or principal is repaid.

Long-term and Short-term Debt

Public debt may either be for a long-term or for a short-term. This is a distinction of degree. The distinction often drawn flanked by “funded” and “floating or unfunded” debt is roughly equivalent to that flanked by long and short-term debt. Funded or long-term debts are repayable after a year while unfunded debts are usually incurred for a short-term and necessity be repaid within a year. It comprises the treasury bills which are issued for a currency of ninety-one-days, ways and means advances from the Reserve Bank of India (less than three months) etc.

PUBLIC DEBT MANAGEMENT

Public debt occupies the minds of politicians, editorial writers, citizens and economists. Intuitions tell us that we would be better off without the debt just as we would wish to be free of personal debts. Yet to sort out the real burden from the fancied requires the mainly careful economic analysis. It is all the more significant because the burden of public debt can be shifted wholly or in substantial part from the present to the future generation. The burden of public debt is not something which can be thrown backwards and forwards through time and made to fall, at will, wholly on one generation or wholly on another. Can large public debt lead to default or bankrupt the government? Default occurs when a borrower fails to meet its financial commitments. Bankruptcy exists when a borrower’s debt far exceeds its skill to meet obligations. The government will neither default nor face bankruptcy since it has the power to tax and print money. Suppose the government has no tax revenue to meet interest payment on its debt, it can secure whatever funds it needs through raising taxes. Alternatively, since it is the sole issuer of paper currency, it can print additional paper currency and use it to meet its interest payments. Therefore with virtual unlimited sources of funds, the government is not prone to default or bankruptcy.

In practice, as a portion of debt falls due each month, government does not usually cut expenditure or raise taxes to give funds to retire or repay the maturing bonds. Rather, the government basically refinances the debt, i.e. it sells new bonds and uses the proceeds to pay off holders of the maturity bonds. Hence public debt management becomes a crucial task or responsibility of the government. Public debt management refers to the task of determining, through the fiscal and monetary authorities, the size and composition of debt, the maturity pattern, interest rates, redemption of debt etc.

In this task, several characteristics need to be kept in view like lowering the rate of interest, adjusting the length of the maturity of debt, providing adequate funds for economic development etc. For instance, if both the central and state governments decide to go in for public borrowing, details need to be worked out concerning the amount, interest rates and other conditions and circumstances accompanying the loans. In India, this task of bringing about the coordination is achieved through -the Reserve Bank of India which is the central monetary authority.

Elements of public debt management

Let us now discuss some of the significant methods usually adopted for the retirement of public debt. These contain the following:

- Refunding
- Conversion
- Surplus Budget
- Sinking Funds
- Terminable Annuities
- Additional Taxation
- Capital levy
- Surplus balance of payments
- Refunding of debt implies the issue of new bonds and securities through the government in order to repay the matured loans. In the refunding procedure, usually short-term securities are replaced through long-term securities. Under this method the money burden of debt is not relinquished but is accumulated owing to the postponement of debt redemption
- Resource Mobilization ...
- Conversion of public debt implies changing the existing loans, before maturity, into new loans at an advantage. In fact, the procedure of conversion consists usually in converting or altering a public debt from a higher to a lower rate of interest. Now, when the rate of interest falls, it may convert the old loans into new ones at a lower rate, in order to minimize the burden. Therefore the obvious advantage of such conversion is that it reduces the burden of interest on the tax-payers. The success of conversion, though, depends upon (i) the credit worthiness of the government, (ii) the maintenance of adequate stock of securities, (iii) the efficiency in managing the public debt. The variation flanked by refunding and conversion is that in the case of the latter, there can be a change in rate of interest and other conditions.

- Quite often, surplus budget (i.e., through spending less than the public revenue obtained) may be utilized for clearing of public debts. But in recent years, due to ever-rising public expenditure, surplus budget is an unusual phenomenon. Moreover, heavy taxes have to be imposed for realising a surplus budget, which may have adverse consequences. Or when public expenditure is reduced for creating surplus budget, a deflationary bias may develop in the economy. Hence this method is not measured appropriate for retirement of any debt.
- A sinking fund is created through the government and it is slowly accumulated every year through setting aside a part of current public revenue to be deposited in the fund in such a way that it would be enough to pay off the funded debt at the time of maturity. Perhaps, this is the mainly systematic and the best method of redemption. Under this method, the aggregate burden of public debt is least felt, as the burden of taxing the people to repay the debts is spread evenly over a period of time. Accumulation of the fund inspires confidence in the middle of the lenders and thereby the credit-worthiness of government increases. A sinking fund is though, a slow procedure of debt redemption. Moreover, throughout an emergency or financial stringency, the government is tempted to encroach upon such funds.
- Terminable Annuities of debt redemption is similar to that of sinking fund. Under this method, the fiscal authorities clear off or repay a part of the public debt every year through issuing terminable annuities to the bond holders which mature annually. This is the method of redeeming debt in installments. Through this method the burden of debt goes on diminishing annually and through the time of maturity, it is fully paid off.
- The simple method of debt repayment is to impose new taxes and get the required revenue to repay the principal amount of the loan as well as interest. This method causes redistribution of income through transferring the possessions from taxpayers to the hands of bond holders. It may also impose burden on future generation if new taxes are levied to repay the long-term debts.
- Capital levy is strongly recommended through Dalton as a method of debt redemption with the least real burden on the society. Capital levy refers to a very heavy tax on property and wealth. It is a once for all tax on the capital assets and estates. It is usually imposed after a war to repay unproductive war debts.
- The retirement of external debt, though, is possible only through an accumulation of foreign exchange reserves. This necessitates creation of a favorable balance of payments through the debtor country through augmenting its exports and curbing its imports, thereby improving the position of its trade balance. Therefore the debtor country has to concentrate on the expansion of its export sector industry. Further,

loans raised necessity be productively utilized, so that they may become self liquidating, posing no real burden to the country's economy.

In developing economies, where external debt has increased tremendously, it is necessary that its burden is reduced through changing the conditions of repayment or rescheduling the debt.

PUBLIC DEBT AND ECONOMIC DEVELOPMENT AND INFLATION

The subsistence of a large public debt does Dose real and potential troubles. Externally held debt is obviously a burden. The payment of interest and principal require the transfer of a portion of real output to other nations. When a developing economy borrows abroad to build a dam or when a state issues bonds to build a school, it acquires an external debt that has to be repaid at some future date. Just as in the case of an individual, the borrowing increases the total possessions accessible initially, but reduces the possessions accessible in the future. To meet the interest and repayment charges owed to the outside world, the government necessity reduce future public spending or raise taxes and thereby reduce private spending. In each case, it cuts total internal resource use. In effect, the borrowing basically creates the possessions that were accessible earlier in exchange for the commitment to pay interest. The initial augment in total accessible possessions is made possible through borrowing done outside the community. Likewise, interest and repayment means that the community gives up possessions to the outside world later.

When government borrows within the country, total possessions accessible to the country as a whole are not increased. The possessions are basically transferred from bond payers i.e. people to the government. Likewise, the interest and repayment charges do not transfer possessions outside the country but only transfer them from the taxpayer to the bondholders. One burden of a public debt is unambiguous. Extra taxes have to be imposed to finance the interest payments. These taxes lead to some loss of real output because of their distorting and disincentive effects. Even though the redistribution of income from the taxpayers to the bondholders is only a transfer payment, it does contribute to the negative effects of the tax system. Therefore dead weight loss is borne year after year as the interest payments continue to be met.

As the debt financing of public spending leads to the decline in investment, there would be another unambiguous loss of output. Future generation would inherit a small stock of capital, an economy with a smaller capability to produce, hence a smaller output. Debt financing also reduces private investment. Firstly under circumstances of full employment and with an unchanged monetary policy, when the government borrowing is competitive with private borrowing, interest rates will be raised through the deficit, and investment will be reduced. This is usually described “Crowding out Effect" (Government borrowing will augment the interest rate and reduce private investment). Secondly, investment may also be reduced through the attendance of an existing public debt. Consumers may consider their bond holdings to be a part of their wealth which would create them feel wealthier, raise their consumption, and cut their saving. Further, the higher taxes to cover the interest necessity have some negative influence on investment. Finally, the subsistence of large debt may have psychological influence on business behaviour. If people really get alarmed over the national debt, the loss of confidence may curtail their investment. The significance of this psychological factor is hard to evaluate.

The average citizen fears the debt mainly as a source of inflation. The debt represents past outlays that were not matched through taxes, hence it measures past government claims to possessions that it could not pay for. If government engages in debt financing when the economy is already at full employment, subsistence of a large public debt tends to shift the consumption schedule upward. This shift will be inflationary. Furthermore, government bonds can be converted into money easily and will have little or no risk of loss. Government bonds, so, constitute a potential backlog of purchasing power which can add materially to inflationary pressures. Throughout periods of inflation, it is very tempting for consumers to utilize this reserve of purchasing power in an attempt to beat rising prices. Such an attempt to tackle inflation will cause more inflation.

Until now we have seen only one side of the coin. There is another side to the public debt i.e., the positive role of public debt in economic development. Both public and private debts play a positive role in a prosperous and rising economy. As economy expands, so does saving. Modern employment theory and fiscal policy tell us that, if aggregate demand is to be sustained at a high stage of employment, this expanding volume of saving or its equivalent necessity be obtained and spent through the consumers, business houses or government. The procedure through which saving is transferred to spenders is debt creation. Whenever government issues bonds, since these are highly liquid and risk free securities, they create an excellent purchase for small and conservative savers. To the extent that the availability of bonds encourage saving, more possessions are freed for investment and economic growth tends to be enhanced,

TRENDS AND STRUCTURE OF PUBLIC DEBT IN INDIA

Modern fiscal policy endorses unbalanced government budgets for purposes of stimulating economic growth and stabilizing the economy, its application leading to a public debt. At the time of Independence, India inherited from the British a dead weight debt of Rs. 300 crore. Since the government had undertaken several programmes of planned development the possessions had to be mobilized through several sources including public borrowing. The rising amount of possessions that were mobilized through the government through domestic or internal borrowing resulted in important growth of internal public debt. The internal debt which was 2054 crore in 1950-51 rose to Rs. 183,183 crore in 1990-91.

Table

Internal and External Debt Scenario (In Rs. hundred crores)

Year	Internal Debt. & Obligation	Internal Debt, to GDP (%)	Central Govt. External Debt.	Total Govt. Debt.	Total Debt. GDP (%)	Total Deficit
1980	0485	0036	0113	0597	0044	0058
1980-81	0559	0035	0123	0682	0043	0058
1982-83	0712	0040	0137	0849	(X)48	0055
1984-85	0801	0039	0151	0953	0046	0061
1985-86	1193	0045	0182	1375	0052	0088
1986-87	1462	0059	0203	1665	0057	(X)76
1987-88	1723	0052	0232	, 1956	0059	0067
1988-89	2041	0052	0257	2298	0058	0079
1990-91 R.E.	27%	0060	0318	3114	0067	0106
1991-92 (Bu)	3181	0061	0356	3537	0074	—

According to Economic Survey 1991, the outstanding internal and external debt of Government of India at the end of 1991-92 is estimated to amount to Rs. 3,54,901.12 crore as against Rs. 3,11,059.21 crore at the end of 1990-91 (RE). Out of this total public debt, internal debt and other liabilities as on 31st March 1992 was 3,19,778.70 crore and external debt as on 31st March 1992 was of the order of 35,122.42 crore. A major portion i.e. over four-fifths of the public debt is internal. And if the focus in the coming year should be slashing the budget deficit and not fiscal deficit, it might grow further and assume alarming proportions. The bulk of the government bonds are held through Indian citizens and institutions — banks, business houses, insurance companies, governmental agencies and trust funds — within the Indian economy. While the internal public debt is a liability for the people (as tax payers), that same debt is simultaneously an asset for the people as it is helping in undertaking several developmental projects. Retirement of the internal debt, so, calls for a gigantic transfer payment whereby Indian individuals and business houses would pay higher taxes and the government, in turn, would pay out that tax revenue to those individuals and institutions in the aggregate in redeeming the bonds which they hold. Although a redistribution of wealth would result from this gigantic financial transfer, it need not entail any immediate decline in the economy's aggregate wealth or standard of living. The repayment of the internally held public debt entails no leakage of purchasing power from the economy of the country as a whole.

External debt

The economic implications of the external public debt are quite dissimilar. India owes this external public debt to foreign governments, foreign banks and international lending institutions such as the World Bank and the International Monetary Fund. External public debt is a liability for the Indian people as tax payers and an asset to foreign lenders. So, retirement of the external public debt would involve Indian households and business houses paying higher taxes and the government would then pay out these tax receipts to lenders abroad. This obviously means a transfer of income and wealth from Indian families and business to foreigners. Therefore, retirement of the external public debt would entail a leakage of real purchasing power out of the economy and a decline in the standard of living of the Indian people.

According to Economic Survey 1991, India's medium and long-term external debt consisting of external assistance on government and non government accounts, external commercial borrowings and International Monetary Fund (IMF) liabilities amount to Rs. 80,135 crore (about 18% of GDP) at the end of 1989-90, including outstanding Non-Resident Indian (NRI) deposits. The country's aggregate debt stock was Rs. 97,966 crore at the end of 1989-90 amounting to over 22% of GDP. External debt obligations have increased more than three times throughout 1980-91. Rising debt servicing is a matter of immense concern, as it is eroding the aid inflow drastically.

The compound growth rate of aggregate debt stock from 1980-81 to 1989-90 has been 20% in rupee conditions and 10% in conditions of U.S. Dollars. There has been a notable change in the composition of debt stock. At the beginning of Sixth Five Year Plan, external debt stock consisted mainly of external assistance which constituted approximately 90% of debt stock. Since then, the share of external assistance in debt stock has declined to less than 70% in 1989-90. External commercial borrowing has registered the fastest growth and accounts for 27% of debt stock in 1989-90.

The declining share of external assistance in inflow of external capital, hardening of conditions of such assistance and rapidly rising rates of interest in the international capital markets contributed to indulgence in the debt service payments in the late 1980s. In the latter half of the decade debt stock grew at a compound rate of about 17.5% while the growth in debt service amounted to about 28.5 per cent per annum. Throughout the decade 1979 and 1989, as a proportion of GNP, external debt rose from 9% in 1979 to 24% in 1989. Not only this, the average rate of interest of external borrowings, which was 2.5% throughout 1979, rose to 6.4% in 1989. Obviously, it implies that the loans in recent years have been taken on high interest rates.

World Bank’s latest debt tables reveal that India’s external debt which stood at $62.50 billion in 1989 rose to an estimated $70,953 billion in 1990. It shows a rise of 13.5% throughout the year and therefore India has become the third mainly indebted country in the world after Brazil and Mexico. This vast debt burden only underlines the fact that in future years interest payment burden is likely to be much larger and India may have to borrow further to fulfill its debt service obligations or we can say that our country is in serious debt trap.

India faced a severe resource crunch in 1991 and contacted the IMF for a loan of $5-7 billion besides the loans contacted from other sources so that the country is bailed out of current foreign exchange crisis. The total debt burden will be in range of $76-78 billion. The vital factor responsible for debt trap is the deteriorating balance of payment (BOP) on current account. The deficit in balance of payments on current account which was of the order of Rs. 2852 crore in 1984-85 has risen to Rs. 10,410 crore in 1988-89.

The purpose of the government’s recent exercise of devaluing Indian Rupee in July ’91 was to boost export and reduce imports, so that the trade gap is narrowed down. Although the government has been creation serious efforts at promoting exports, all its efforts are getting a setback through the rising imports. It is so, imperative that a screening of imports be accepted out and non-essential imports slashed with an iron hand. The philosophy of import led growth should be abandoned in favor of the philosophy of import substitution and self-reliance.

To relieve the situation, it became imperative for the country to secure a loan from the IMF/World Bank to tide over the present crisis. There is a need to convert commercial loans bearing high rates of interest into low interest bearing institutional loans. Such a rescheduling of loans can help to reduce the debt service burden. Another short-term measure may be to cajole the NRIs into investing in areas either certainly mitigate the present foreign exchange scarcity. Another suggestion is to permit direct foreign investment through multi-national corporations. But while permitting foreign private investment, vigilance has to be maintained to ensure that the investment helps to upgrade our technology and capability of production in the capital goods sector.

Though, devaluation, liberalization or direct foreign investment cannot succeed unless domestic economy is improved. The external debt situation cannot be analyzed effectively in isolation from the domestic debt situation. Consequently the policies aimed at correcting the balance of payment situation have to be connected with economic reforms to contain the fiscal deficit.

There is so, the need for evolving an overall strategy of development which should help to restore the macroeconomic balance within the country and also limit our dependence on external debt. Here comes the role of the Reserve Bank of India in managing public debt.

ROLE OF RESERVE BANK OF INDIA IN PUBLIC DEBT MANAGEMENT

The Reserve Bank of India and its several offices and representatives have the responsibility to assist the economy in achieving sustained economic growth without inflation through its monetary policy. Monetary policy consists of altering the economy's money supply for the purposes of attaining rising stages of output and employment on the one hand and stability in the price stages on the other. More specifically, monetary policy entails achieving two inter-related goals. First, it necessity expand the supply of money in the long run to meet the demand for money in a rising economy and, second, it necessity adjust the money supply to curb economic fluctuation, i.e., throughout recession to stimulate spending and, conversely, restrict the money supply throughout inflation to constrain spending.

The Reserve Bank of India as the central monetary authority has a significant role to play in public debt management. It helps the central and state governments to float new loans and manage public debt. The ownership pattern of public debt in India reveals that the Reserve Bank of India and other commercial banks continue to have the major ownership of the debt. The Reserve Bank continues to be the largest single holder of Central government securities. It has undertaken considerable buying and selling of government securities. Hence whenever government resorts to public borrowing, the Reserve Bank of India buys its securities. The readiness of the Reserve Bank of India to contribute to government loans, whenever they are floated, prevents the government from borrowing from other sources at a higher rate of interest.

The Reserve Bank of India is entrusted with the responsibility of imposing credit control measures from time to time. The Banking Companies (Amendment) Act, 1962 requires the commercial banks to maintain liquidity ratio of sure percentage of their time and demand liabilities with the Reserve Bank. This facilitates the commercial banks to borrow money from the Reserve Bank whenever required. This Statutory Liquidity Ratio (SLR) was raised from 38% to 38.5% of all demand and time liabilities of commercial banks. Another method of credit control is through the system of cash reserves where the commercial banks are required to maintain a minimum amount of liquid assets with the Reserve Bank of India. This Cash Reserve Ratio (CRR) was left unchanged at its existing legal maximum of 15% of all net demand and time liabilities of commercial banks. In times of need, the banks can borrow from the Reserve Bank of India on the basis of eligible securities.

An significant step towards rationalization of the interest rates structure was taken through Reserve Bank of India when it introduced a new regime of lending rates for commercial banks with effect from 22nd September, 1990 and replaced the earlier programme specific, sector specific and region specific interest rates related to the size of a dances, except for export credit and the Differential Rate of Interest (DRI) scheme. The rates of interest were again revised on 9th October, 1991 in view of the changes made in Budget of 1991. The Reserve Bank of India therefore regulates the banking structure through imposition of such liquidity restrictions concerning credit supply.

Large public debt imposes constraint upon effective monetary (interest rate) policy. The vital dilemma is flanked by the government's desire for low interest costs, on the one hand and the goals of economic stability and growth on the other. More specifically, throughout periods of inflation, the monetary authority should restrict money supply which will raise interest rates and thereby tend to limit spending.

DEFICIT FINANCING

DEFICIT FINANCING — CONCEPT AND MEANING

Deficit financing refers to means of financing the deliberate excess of expenditure over income through printing of currency notes or through borrowings. The term is also usually used to refer to the financing of a planned deficit whether operated through a government in its domestic affairs or with reference to balance of payment deficit.

In the West, the phrase "Deficit financing" has been used to describe the financing of a deliberately created gap flanked by public revenue and expenditure or a budgetary deficit. This gap is filled up through government borrowings which contain all the sources of public borrowings viz., from people, commercial banks and the Central Bank. In this manner idle savings in the country are made active. This increases employment and output. But according to Indian budgetary documents government resorting to borrowing from the public and the commercial banks does not come under deficit financing. These are incorporated under the head of 'Market Borrowings' and government spending to the extent of its market borrowings does not result in or lead to deficit financing.

In the Indian context, public expenditure, which is financed through borrowing from the public, commercial banks are excluded from deficit financing. While borrowing from the central bank of the country, withdrawal of accumulated cash balances and issue of new currency are incorporated within its purview. Deficit financing in Indian context occurs when there are budgetary deficits. Let us now discuss the meaning of budgetary deficit. Budgetary deficit refers to the excess of total expenditure (both revenue and capital) over total receipts (both revenue and capital). In the words of the First Plan document, the term 'deficit financing' is used to denote the direct addition to gross national expenditure through budget deficits, whether the deficits are on revenue or on capital account. The essence of such a policy lies, so, in government spending in excess of the revenue it receives in the shape of taxes, earnings of state enterprises, loans from the public, deposits and funds and other miscellaneous sources. The government may cover the deficit either through running down its accumulated balances or through borrowing from the banking system (mainly from the Central Bank of the country) and therefore 'creating money'. Therefore, the government tackles the deficit financing through approaching the Central Bank of the country i.e. Reserve Bank of India and commercial banks for credit and also through withdrawing its cash balances from the Central Bank.

The magnitude of actual budget deficit throughout the seventh plan had been of the order of Rs. 29,503 crore (at 1984-85 prices) which was more than double the estimate of Rs. 14,000 crore. The Budget for 1990-91 laid stress on limiting the size of the budget deficit through containment of expenditure growth and better tax compliance. The budget programmed a deficit of Rs. 1, 10,592 crore in 1989-90. The revised estimates for the year 1990-91 placed the budgetary deficit at Rs. 10,772 crore which is almost 50% higher than the budget estimate. Proper financial management demands that the revenue receipts of the government, which are in the shape of taxes, loans from the public, earnings of the state enterprises etc., should not only meet the revenue expenditure but also leave a surplus for financing the plan. Contrary to this deficits on revenue account are rising year after year. For instance the revised estimates place the deficit on revenue account throughout 91 at Rs. 17,585 crore as against the budget deficit of Rs. 10,772 crore. A higher revenue deficit implies higher borrowed possessions to cover the deficit leading to higher interest payments therefore creating a sort of vicious circle.

ROLE OF DEFICIT FINANCING AS AN AID TO FINANCING ECONOMIC DEVELOPMENT

Deficit financing has been resorted to throughout three dissimilar situations in which objectives and impact of deficit financing are quite dissimilar. These three situations are war, depression and economic development.

Deficit financing throughout war

Deficit financing has its historical origin in war finance. At the time of war, approximately every government has to spend more than its revenue receipts from taxes and borrowings. Government has to make new money (printed notes or borrowing from the Central Bank) in order to meet the necessities of war finance. Deficit financing throughout war is always inflationary because monetary incomes and demand for consumption goods rise but usually there is shortage of supply of consumption goods.

Deficit financing throughout depression

The use of deficit financing throughout times of depression to boost the economy got impetus throughout the great depression of the thirties. It was Keynes who recognized a positive role for deficit financing in industrial economy throughout the period of depression. It was advocated that throughout depression, government should resort to construction of public works wherein purchasing power would go into the hands of people and thereby demand would be stimulated. This will help in fuller utilization of already existing but temporarily idle plants and machinery. Deficit spending through the government throughout depression helps to start the stagnant wheels of productive machinery and therefore promotes prosperity.

Deficit financing and economic development

Deficit financing for development, like depression deficit financing, gives incentive to economic growth through financing investment, employment and output in the economy. On the other hand “development deficit financing” resembles “war deficit financing” in its effect on the economy. Both are inflationary though the reasons for price rise in both the cases are quite dissimilar. When government resorts to deficit financing for development, large sums are invested in vital heavy industries with long gestation periods and in economic and social overheads. This leads to immediate rise in monetary incomes while production of consumption goods cannot be increased immediately with the result that prices go up. It is also described the inflationary way of financing development. Though, it helps rapid capital formation for economic development.

DEFICIT FINANCING AND INFLATION

Deficit financing in a developing country is inflationary while it is not so in an advanced country. In an advanced country the government resorts to deficit financing for boosting up the economy. There is around unemployment of possessions which can be employed through raising government investment through deficit financing. The result will be an augment in output, income and employment and there is no danger of inflation. The augment in money supply leading to demand brings about a corresponding augment in the supply of commodities and hence there is no augment in price stage.

But, when, in a developing economy, the government resorts to deficit financing for financing economic development the effects of this on the economy are quite dissimilar. Public outlays financed through newly-created money immediately make monetary incomes and, due to low standards of living and high marginal propensity to consume in general, the demand for consumption of goods and services increases.

But if the public investment is on capital goods, then the increased demand for the consumer goods will not be satisfied and prices will rise. Even if the outlay is on the production of consumption goods the prices may rise because the monetary incomes will rise immediately while the production of consumer goods will take time and in the meanwhile prices will rise. Though investment is being continuously raised (through taxation, borrowing and external assistance), mainly of it goes to industries with long gestation period and for providing vital infrastructure. Though there is effective demand, possessions lie under or unemployed. Lack of capital, technical ability, entrepreneurial skills etc. are responsible in several cases for unemployment or underemployment of possessions in a developing economy. Under such circumstances, when deficit financing is resorted to, it is sure to lead to inflationary circumstances.

Besides, in a developing economy, throughout the procedure of economic development, the velocity of circulation of money increases through the operation of the multiplier effect. This factor is also inflationary in character because, on balance, effective demand increases more than the initial increases in money supply. Deficit financing gives rise to credit creation through commercial banks because their liquidity is increased through the creation of new money. This shows that in a developing economy total money supply tends to augment much more than the amount of deficit financing, which also aggravates inflationary circumstances. The use of deficit financing being expansionary becomes inflationary also on the basis of quantity theory of money.

DEFICIT FINANCING AND PRICE BEHAVIOUR IN INDIA

Price stability is an essential condition for stability in economic life as well as economic growth. On the contrary, fluctuations in prices make an atmosphere of uncertainty which is not conducive to development activity. When we look at the price movements throughout the planning period in India, there are three clear trends. First throughout the first plan period (i.e. 1951 to 1956) the general price stage had fallen. From 1955-56 to 1965-66, the prices rose steadily at an annual rate of 6%. Finally, from 1966-67 onwards (except 1975-76 and 1977-78) prices rose at the rate of about 9% per annum and now it is in the double digit range.

Deficit financing as a tool for covering the financial gap in India was introduced at the time of formulation of first five year plan. Throughout the first plan deficit financing was of the order of Rs. 333 crore and the money supply with the public increased through about 22 per cent. Since this expansion in the supply of money fell short of the augment in output, the general price stage came down through about 18 per cent. Throughout second plan, actual deficit financing was less than the targeted amount. The third plan was very abnormal (adverse weather circumstances, 1962 Chinese aggression, 1965 Pakistan war). Deficit financing throughout the third plan amounted to Rs. 1333 crore — more than double the target. Money supply with the public-increased more rapidly.

In the fourth plan (1969-74), the amount of deficit financing stood at Rs. 2060 crore about two-and-a-half times the target. Money supply increased from 6387 crore to Rs. 11,172 crore at the end of 1973-74. Prices increased through 47% almost. No doubt there were sure factors beyond the control of the government such as war with Pakistan in 1971, substantial expenditure on account of Bangladesh refugees, oil price hike etc. Besides, the reluctance on the part of the states to mobilize adequate possessions, their general financial indiscipline and overdrafts from the Reserve Bank also compelled the government to take resort to deficit financing.

In view of severe inflationary pressures in the economy since 1972-73, the draft fifth plan 1974-79 laid utmost stress on non-inflationary methods of financing. But. as against the target of Rs. 1354 crore for the fifth five year plan, the actual amount of deficit financing was much more. Throughout this period, although the money supply increased through about 50 per cent, the overall augment in wholesale prices was 33% because of the imposition of emergency in 1975 resulting in comfortable position in regard to the availability of many commodities through the effective management of supplies.

Throughout the sixth plan (1980-85) deficit financing was of the order of Rs. 15,684 crore as against the estimated target of Rs. 5000 crore. Throughout this period money supply increased from Rs. 23,117 crore-in 1980-81 to Rs. 39,380 crore in 1984-85. Seventh plan paper indicated a careful approach towards deficit financing and stated that “The required possessions have to be mobilized in a manner which minimize dependence on external sources or on deficit financing which has a high inflationary potential." Still the target for deficit financing was placed at Rs. 14,000 crore and according to the latest estimates the actual deficit financing has been of the order of Rs. 34,182 crore i.e. more than 2.4 times the target. Money supply with the public has increased from Rs. 43,599 crore in 1985-86 to Rs. 76,259 crore in 1988-89 and index of wholesale prices has gone up from 357.8 to 435.8 throughout the same period.

There were several other factors like mismanagement of the war economy, excessive dependence on monsoon, power shortage, labour strikes, augment in the rates of commodity taxation, rise in wage rates, black money, rise in the international price of petroleum products which have been responsible for price rise in India. Though, experience shows that the augment in money supply has led to a rise in prices. There has been a secure relationship flanked by the rate of augment in prices and the rate of growth in money supply and prices have a tendency to rise to new heights at every successive augment in money supply resulting from deficit financing.

When deficit financing is inflationary, it will go against the very purpose for which it is used because it will basically lead to continuous inflation and no development. Inflation makes uncertainty, labour unrest, work stoppages and decline in production because of the demand for higher wages and salaries to compensate for higher cost of living. Inflation reduces the real income and the real consumption of all classes of people in the society except the rich. This is objectionable on grounds of economic efficiency, labour productivity and social justice. Moreover, there is no certainty that higher stages of income accruing to profit earners will be invested into productive enterprises, for the rich may waste windfall gains in conspicuous consumption or indulge in speculative activities. Besides, inflation is a sort of invisible tax on all incomes and cash balances. Their value is automatically reduced with every rise in prices. Inflation leads to balance of payments difficulties because due to rising prices the country loses export market and people prefer imported goods, which appear cheaper as compared to domestic goods.

Inflation is charged with distorting the pattern of investment and production in the economy. Inflation is beset with the danger of channelizing economic possessions into less urgent and speculative fields where the scope for profits to private enterprises is more and such fields are usually of little importance to the nation. Inflationary deficit financing increases the administrative expenditure of the government because whenever government resorts to large doses of deficit financing; it has to neutralize its effects through sanctioning new dearness allowances, revision of controlled prices, sharing of essentials through fair price shops, compulsory requisition of foodstuffs etc. All these measures lead to an augment in the administrative burden of the government in order to ward off inflation caused through the use of deficit financing.

ADVANTAGES OF DEFICIT FINANCING

Uphill now, we have seen that deficit financing is inflationary and it destroys its own purpose of aiding economic development. But it is not always so. Secondly inflation is not always harmful for economic development. On the contrary, to a sure extent inflation is conducive to economic development and hence deficit financing is beneficial.

Throughout the procedure of development, augment in national production is bound to provide rise to the demand for increased money supply for transactions. This can be met through injecting new money in the economy through deficit financing. If deficit financing is resorted to for productive purposes especially for the production of consumer goods and that too for quick results then deficit financing is not that inflationary. For instance, if any land reclamation activity is to be undertaken which would lead to agricultural production, resort to deficit financing for this activity will not be inflationary. Even if there is a moderate price augment of 4 to 5% per annum, its impact on the economy will not be too severe. Besides, deficit financing will not be inflationary if it is matched through a balance of payment deficit. To the extent to which past savings of foreign balances can be used to pay for such imports, it would be deflationary. But much reliance cannot be put on balance of payments deficit because balance of payments deficit depends on our foreign exchange reserves and our credit worthiness in the world market. Moreover, a developing country aims at reducing this deficit through rising exports and reducing imports.

Deficit financing will be non-inflationary if the government is able to mop up the additional money incomes, created through deficit financing, through taxation and saving schemes. Properly controlled and efficiently supervised programme of deficit financing may help the procedure of economic development. In fact a sure measure of deficit financing is inevitable under planned economic development to activate unutilized or dormant possessions especially when one of the objectives of planning is to step up the tempo of economic procedure. Inflationary impact of deficit financing is helpful for economic development to a sure extent and under sure circumstances like:

- Under developed countries, with their low incomes, low or negative savings, inadequate investment and traditional resistance to change and modernization, will remain stagnant or develop at an intolerably slow pace unless they are restructured and activated. This can be done with the incentive of inflation.
- Inflation stimulates economic activities and rising prices induce more ' investments. In a developing economy the major goal is rapid economic development through speedy capital formation. The additional income that is earned through inflation can be ploughed back and if the same procedure is repeated there is every possibility of a rapid rate of capital formation in the country. For this, inflation may be tolerated to a sure extent.
- Inflation is said to be a useful method of rising saving in a forced way. There will be redistribution within the private sector of the economy, from the personal sector to corporate sector. Inflation reduces real consumption and gives possessions for investment purposes.

Therefore, deficit financing is a necessary and positive instrument to accelerate the rate of economic growth in countries suffering from acute shortage of capital. But any deficit financing has to be undertaken in the context of an efficient and well executed plan for economic development.

LIMITATIONS OF DEFICIT FINANCING

Deficit financing (as we have examined uptill now) can be regarded as a necessary evil which has to be tolerated, at least in the developing economies, only to the extent it can promote capital formation and economic development. This extent of tolerance is described the safe limit of deficit financing. This safe limit shows the amount of deficit financing that the economy can absorb and beyond which inflationary forces may be set in motion. Though it is not possible to quantify it, yet it is desirable to identify the factors that affect it.

Factors that affect deficit financing can be put under two categories: (a) factors related to demand for money and (b) factors related to supply of money. If the demand for money is low in the economy, the safe limit of deficit financing will be low. Then creation of new money or deficit financing necessity be kept at a low stage otherwise evil consequences will follow. Reverse will be the case when demand for money is high. On the supply side of money, if due to some factors the supply of money or purchasing power with the public increases, other things being equal, it will have an inflationary tendency and the safe limit of deficit financing will be low. Though, safe limit will be high in the opposite situation.

The concept of 'safe limit' of deficit financing can be reduced to the age old theory of demand and supply. The point at which demand for and supply of money are equal is the point of safe limit of deficit financing. Unluckily circumstances in a developing country are not so simple. Several factors simultaneously exert contradictory effects on each side.

Factors Affecting Safe Limit

- The safe limit of deficit financing depends on the supply elasticity of consumption goods in the country. Usually, the supply of consumption goods, specially food grains, cannot be increased to any extent for a long time due to several constraints in a developing economy. Under such circumstances even a little deficit financing would be inflationary and the safe limit of deficit financing will be very low.
- Safe limit of deficit financing also depends on the nature of government expenditure for which new money is created, i.e., the purpose of deficit financing. If the newly created money is used for unproductive purposes, the use of deficit financing will be inflationary and the safe limit of deficit financing will be lower than if the newly created money is to be used for industrial development or for rigorous fanning.
- If the foreign exchange reserves are rising the scope of using deficit financing will augment because that way the country will be able to import more goods which will have deflationary effect.
- Time lag flanked by the initial investment and the flow of final products also determines the safe limit of deficit financing. If this time lag is long, then inflation will set in from the very initial stage of investment and it will not be possible to control the rapidly rising prices.
- Low safe limit of deficit financing is required if the economy consists of large speculative business community.
- If government is not in position to implement successfully its economic policies accompanying the policy of deficit financing, low safe limit of deficit financing is prescribed.
- If a country is already passing through inflationary stage, low deficit financing is advised.
- If the rate of growth of population is high then low deficit financing is good and vice versa.
- Safe limit deficit financing also depends on a country's tax structure and the borrowing schemes through which the government can take absent at least a portion of additional incomes thereby reducing the purchasing power with the public. But all this is not easy in a

developing economy where there are rigidities in the tax system. There is large scale tax evasion so that government is not able to take absent any substantial part of additional incomes. The country is, so, more prone to inflation and the safe limit of deficit financing is low.

In a developing economy, all the aforesaid factors exert their influence simultaneously. The effect of each factor may be favorable or unfavorable for the use of deficit financing and sometimes the effects of some factors may counter effect each other and, therefore, be cancelled out. This safe limit of deficit financing will be dissimilar for dissimilar countries because circumstances vary from country to country. The safe limit of deficit financing also depends on the measure of popular cooperation which the government gets and the willingness of the people to submit to austerity. Even if this limit is calculated, it will go on changing with every change in the economic circumstances of the country. With efforts in the right direction this limit can be shifted upwards so that a larger amount of deficit financing can be resorted to through a government which is conducive to economic development and not inflation.

MEASURES/ALTERNATIVES TO CONTROL DEFICIT FINANCING

Besides open deficit financing undertaken through the government, there is concealed deficit financing in developing economies. In all government departments, in a developing country mainly of the expenditure is incurred recklessly in the last few weeks of the financial year so that the amount sanctioned may not lapse. This reckless expenditure is largely a waste and is not accompanied through expected results. This expenditure is fairly large every year. It is not productive and it leads to price rise and operates in the economy in a manner similar to deficit financing. Mainly of the havoc created in the economy is actually created through this concealed deficit financing. If, through efficient and honest administration, this vast wasteful expenditure can be avoided, the officially acknowledged deficit financing will not be so inflationary.

Anti-social acts such as evasion of taxes, black marketing, cash transactions to supplement recorded cherub transactions, under invoicing and over invoicing of export and imports, and a diversity of such forms of corruption on the part of the private parties lead to large volume of 'unaccounted money'. This money is to be spent recklessly and it leads to inflationary rise in prices. Government necessity try to remove reckless expenditure in public and private sectors caused through 'concealed deficit financing' and 'unrecorded gains' instead of stopping the use of deficit financing which is likely to be spent productively and so help in the economic development of the country.

In order to minimize the inflationary effects of deficit financing throughout the procedure of development the government will have to keep a vigilant and constant watch on changing economic situations, revise the repercussions of measures adopted in many spheres and, above all, take effective action on following lines:

- Government should try to drain off a larger proportion of funds resulting from deficit financing through saving campaign and higher taxation.
- The policy of deficit financing should be adopted as a last resort, after exhausting all other possible sources of development finance.
- Investment should be channeled into those areas where capital output ratio is low so that returns are quick and price rise is not provoked.
- Beside with deficit financing, government should adopt policies of physical controls like price control and rationing etc.
- Import policy should allow import of necessary capital equipment for economic development and consumer goods required through the masses alone. Import of luxury and semi-luxury goods should be discouraged.
- Deficit financing and credit creation policies should be integrated in such a way that neither of the two sectors (public or private) is handicapped due to shortage of financial possessions and, at the same time, inflation is also kept in check in the economy**.**

Above all these policies, what is more required is that the government should try to seek full public cooperation and people should have full faith in the policies of the government so that government policies can be successfully implemented. Deficit financing or no deficit financing, the procedure of economic development itself is inflationary. Whenever new investment is financed through taxation or borrowing, the result is an augment in monetary incomes, augment in demand for consumption goods, and price rise. With this background the significant question, in a developing country, is not whether deficit financing should be resorted to or not for economic development, but, rather, how far inflation can be pushed without upsetting the productive procedure. Therefore deficit financing is a necessary and positive instrument to accelerate the rate of economic growth in countries suffering from acute shortage of the capital, though it is necessary to emphasize here that it necessity be undertaken with an efficient and well executed plan for economic development.

SOURCES OF REVENUE: TAX AND NON-TAX

TAX REVENUE — CONCEPTS AND CLASSIFICATION

The income of the government may be defined either in a broad or narrow sense. In a broad sense it comprises all 'incomings' or 'receipts' and in the narrow sense only those receipts which are incorporated in the ordinary concept of revenue. The chief elements which are incorporated in the concept of public receipts but excluded from that of public revenue are receipts from public borrowings and from the sale of public assets. The mainly significant source of government revenue is from taxes. A tax is a compulsory charge imposed through a public authority, like for instance income tax. Sometimes account of taxes cover penalties for offences. The distinction flanked by taxes and penalties is one of motive; a public authority imposes taxes mainly to obtain revenue and resorts to penalties mainly to deter people from doing sure things. So, a tax is a compulsory contribution imposed through a public authority, irrespective of the exact amount of service rendered to the tax payer in return, and not imposed as a penalty for any legal offence.

The commonest classification of taxes is flanked by direct and indirect taxes. Direct tax is imposed and composed directly from the person on whom it is legally imposed while an indirect tax is imposed on one person, but paid partly or wholly through others. Therefore an indirect tax is conceived as one the incidence of which can be shifted or passed on to another person, while the incidence of the direct tax falls on the person concerned and cannot be shifted or passed on to another person. Now let us discuss in detail the kinds of direct and indirect taxes.

Direct Taxes

Income Tax, Corporation Tax, Capital Gains Tax, Estate Duty, Gift Tax, Wealth Tax come under the category of direct taxes. In the case of direct taxes the liability is determined with direct reference to the taxpayer's tax-paying skill, while in the case of indirect taxes, this skill is assessed indirectly. For instance, in case of income tax which is a direct tax, the amount of tax to be payable through a person, is determined on the basis of that person's income.

Income-Tax

This is the tax which is levied on the total income of the tax payer after reducing prescribed deductions. In India, the first Income Tax Act was passed in 1886. Later in 1922, a comprehensive act was passed. In 1961, this Act was repealed and a new Income Tax Act was passed. Under the Income Tax Act, income comprises salaries, interest on securities, profits and gains of business and professions, capital gains, value of any benefit or perquisite, any winnings from lotteries, other games etc. But income derived from agricultural activities is exempted from income tax till date.

There are changes made in the rates of income tax from year to year. Also under the Indian Income Tax Act sure incomes are totally exempt from tax. Some of these contain, accumulated balance of recognized provident fund, death-cum-retirement gratuity, house-rent allowance upto a sure limit, scholarships granted to meet educational costs, post-office savings etc.

The budget 1991-92 proposed sure major changes in the rate structure of income-tax. The exemption limit for personal income tax was raised from Rs. 18,000 to Rs. 22,000 i.e. income tax will be levied only on annual incomes exceeding Rs. Any person getting an annual income upto Rs. 22,000 need not pay any income tax. The lowest tax rate of 20% has been extended from the existing limit of Rs. 25,000 to Rs. 30,000. Under the new system introduced for 1991-92, a person contributing to provident fund, Life Insurance Corporation etc., can now be entitled only to a tax rebate calculated at the rate of 20% on such savings.

Corporation tax

In India, the companies are subjected to tax on their incomes which is described Corporation tax. Separately from this, the companies deduct tax at source from the dividends of shareholders and deposit them with the authorities. Hence whatever dividend a shareholder gets is the amount received after deduction of tax. The Corporation tax which is levied on the income of the Company is dissimilar from this. This is levied at a flat rate and subject to a number of rebates and exemptions. These rebates and exemptions vary according to activities, criteria, kinds of corporate income.

The Budget of 1991-92 reduced the tax rate for widely held domestic companies from the existing rate of 50% to 40%. As a measure of relief the deduction for setting up new industries was raised from 25% to 30% in the case of companies and from 20% to 25% in the case of others. This benefit can now be availed of for 10 years as against 8 years.

Tax on Capital Gains

This is the tax levied on the sale of any asset like land, structure etc. when the price at which it is sold or transferred exceeds the price at which it was purchased or acquired. In India, any profits or gains arising from the transfer of a capital asset are taxed under the head ‘capital gains’. Though, sure capital assets have been excluded from the purview of this tax, like consumable stores, raw materials, furniture etc.

Expenditure Tax

This tax was introduced in 1958 in India. The tax was levied on persons and Hindu Undivided Families whose income from all sources throughout the relevant previous year, after deducting all taxes on such income, exceeded Rs. It was introduced on the recommendation of Prof. Kaldor who felt that expenditure was easily definable than income as the basis of taxation and it was a better index of taxable capability. But later in 1962, it was abolished, as it failed in curtailing extravagant consumption or checking the evasion of other taxes. Again in 1987, the Expenditure Tax Act was introduced which gives for levy of a tax on expenditure incurred in hotels where the room charge for any unit of accommodation is Rs. 400 or more per day per individual. The rates of expenditure tax have been raised w.e.f. 1.6.1989 from 10% to 20% of expenditure incurred in connection with provision of any accommodation, food, drinks and sure other categories of services. It will not apply to expenditure incurred in foreign exchange or in the case of persons enjoying diplomatic privileges.

Wealth Tax

The Wealth Tax Act, 1957 gives for levy of a tax on the net wealth of every individual, Hindu Undivided Families and companies which are closely held. Agricultural property is not incorporated in the net wealth of an individual. But possession of amount of wealth to a sure limit is exempted from wealth tax. The Finance Act of 1985 enhanced the vital exemption under the Wealth Tax Act from Rs. 1.5 lakhs to Rs. 2.5 lakhs in respect of individuals and Hindu Undivided Families. The maximum rate of tax was also lowered from 5% of the taxable wealth to 2% if the assessable wealth exceeds 30 lakhs in respect of individuals and Hindu Undivided Families.

Estate Duty

The estate duty was introduced in India in 1953. It was levied on the total property passing or deemed to pass on the death of a person. The duty was leviable on all property belonging to the deceased who incorporated cash, jewellery, household goods etc. A slab system was fixed according to which tax was levied. Later several changes were brought about under several acts in the rate of tax. The Estate Duty (Amendment) Act 1984, discontinued estate duty on agricultural land. The levy of estate duty in respect of property (other than agricultural land) passing on death occurring on or before 16 March, 1985 has also been abolished under the Estate Duty (Amendment) Act, 1985.

Gift Tax

Gift tax was introduced in India in 1958. It is a tax imposed on gifts made through individuals, Hindu Undivided Families, Corporations, on the value of the taxable gifts made through them throughout the year. It is paid through the person giving the gift. Initially gifts upto Rs. 10,000 were exempted from the tax. Later changes were brought about in the exemption limits. According to the 1991-92 Budget, gift tax is levied on gifts exceeding a value of Rs. 20,000, subject to sure exemptions. These exemptions contain gifts to charitable institutions, female dependents on the occasion of marriage, gifts to spouse etc.

The direct taxes as discussed above are the sources of revenue to the Central Government. The proceeds of some of the above taxes though composed through the Union Government are distributed flanked by the Union and states. The direct tax revenues of the State governments contain the State’s share of income tax, estate duty; land revenue, urban immovable property tax etc.

Indirect Taxes

Having dealt with the several kinds of direct taxes, which form the source of revenue to the Central government, let us now discuss about the indirect taxes. In our taxation system a heavy reliance is laid on indirect taxes which amount to around 83%. Indirect taxes contain sales tax, excise duties, entertainment tax, customs duties etc. One of the significant reasons for rising revenue from indirect taxes is with rising financial necessities of revenue, it is easier to impose and revise the indirect taxes than direct taxes.

Customs Duty

These are taxes imposed on goods entering (import duties) or leaving (export duties) a customs area. Taxes imposed on goods imported from abroad are import duties while those levied on goods exported from the country are export duties. There are broadly three kinds of customs duties - import duties, export duties and cesses on exports.

Import duties

These are levied according to the rates of duty prescribed under Schedules I and II of the Indian Tariff Act 1934. A commodity schedule prescribes the dissimilar rates of import duties leviable on dissimilar commodities. Usually luxury items are charged the highest with a view to discouraging their import while low rates are charged for essential items.

The net customs revenue has been estimated at Rs. 20,800 crore throughout 1990-91 and Rs. 26,410 crore in 1991-92 after taking into account the changes brought under the Finance Act 1990. As against the original estimate of Rs. 21,213 crore, revised estimate for 1990-91 with regard to import duties, is placed at Rs. 20,562.65 crore. The estimated decrease in gross revenue is mainly on account of less revenue realization from project imports, electrical machinery, iron and non-alloy steel, stainless steel, non-ferrous metals, motor vehicles and parts thereof, organic and inorganic chemicals, glass and glassware etc. This decrease in estimated revenue realization is likely to be balanced to a great extent through increased collection of import duties from crude oil and other petroleum products, machine tools, plastics, rubber products, railway locomotives and materials etc.

Anticipated import duty realization (net) in 1991-92 shows an augment of Rs. 5,508.79 crore as compared to the revised estimate of 1990-91. The augment in gross revenue is expected mainly from crude petroleum and other petroleum products, electrical and no electrical machinery, project imports, chemicals, transport equipment. Budget estimates for 1991-92 take into account the impact of adjustment of exchange rates effected in July 1991.

Export duties

Export duties before World War II, were levied with the prime objective of mobilizing revenue. Later, throughout the post war period, they have been levied for other purposes. According to the Report of Taxation Enquiry Commission (1953-54), “many duties have been imposed for preventing the impact on domestic markets of inflationary circumstances abroad, or for stabilizing domestic prices, while other duties have been imposed for protective purposes.”

In the initial years of planning, the share of export duty in the total indirect taxes was quite high as throughout that time India had a foreign market monopoly for the staple products. But later, due to decline in India’s monopoly in staple products, it became essential to reduce the rates of duties on several commodities like jute, tea, textiles and through the end of the third plan, these duties had to be practically abolished. Later again in 1966, these export duties were reemployed on several items due to competitive position of goods in international market.

Export duties are increased, reduced or abolished through the government from time to time keeping in view several factors like the production of the commodity, its exportable surplus, its demand and prices in international market, etc. But the share of export duties in total indirect taxes is showing a downward trend, mainly due to expansion in revenue from the union excise duties. The revised estimate of net collections from export duties in 1990-91 is placed at Rs. 1.00 crore as against the original estimate of Rs. 6.15 crore. The budget estimate for 1991-92 has been placed at Rs. 0.10 crore.

Union Excise Duties

These are taxes or duties imposed upon the domestic production of commodities for sale or consumption within the country. In India, under the Constitution, excise duty can be levied only through the Union Government, other than those on alcoholic liquor, opium, narcotic drugs etc. On which the state governments levy state excise duties. In recent years, excise duties have become a significant source of revenue for the Government of India because of rising indigenous production of commodities.

Excise Duties can be specific or ad valorem. It is specific when levied at a specified rate per unit of the physical product. 'Ad Valorem' duty is related to the monetary value of the commodity and levied at sure percentage of this value. Union excise duties are levied on commodities sheltered through the Central Excises and Salt Act 1944 and other special acts enacted from time to time. The commodities are grouped into 139 budget heads. A number of commodities are though exempted from duty. The receipts throughout 1990-91 are estimated at Rs. 24,500 crore as against the budget estimate of Rs. 25,125.03 crore (after taking into account the effect of changes made in the Finance Act 1990) showing a decrease of Rs. 625.03 crore. The decrease in vital and special excise duties in the revised estimate of 1990-91 as compared to the budget estimate is mainly on account of less revenue realization from cess on crude oil, petroleum products, iron and steel, rubber products, etc.

Other Taxes and Duties

In addition to the above taxes there are other taxes such as foreign travel tax, inland air travel tax, foreign exchange conservation tax, water cess etc. These taxes do not fall directly in any of the categories. These taxes are classified under the head 'other taxes'.

Foreign Exchange Conservation (Travel) Tax

In conditions of this Act, a person drawing exchange for travel abroad is required to pay, Foreign Exchange Conservation (Travel) Tax at the rate of fifteen per cent on the rupee equivalent of the foreign exchange released to them. This has been made effective from 5th October 1987. An authorized dealer or a money changer collects the tax from a traveler in respect of all foreign exchange released through him/her. Though, the following categories of foreign travel are exempted from payment of the tax:

- Medical treatment
- Studies abroad
- Haj and Ziarat pilgrimages
- Visits to Sikh shrines in Pakistan and Bangladesh
- Visits to Kailash Mansarover
- The Foreign Travel Tax Scheme was introduced with effect from 15 October, 1971 through Finance Act, 1971. This was further amended through the Finance Act 1989. The amended scheme gives for a levy of a tax of Rs. 300 per passenger for international journey, (Rs. 150 for journey to the neighboring countries). One per cent of the collection made, less refund, is paid to the carrier as collection charges.
- Inland Air Travel Tax was introduced through Finance Act 1989. The tax which was levied earlier at a rate of 10% of the vital fare is now levied on the full fare.
- Water (Prevention and Control of Pollution) Cess is levied on industries and local authorities on use of water, under the Water Cess Act, 1977. The receipts are initially credited to the Consolidated Fund of India. The net proceeds are distributed to the state water pollution boards under a prescribed formula.

The indirect revenues of state governments contain state’s share of union excise, state excise, general sales tax, motor vehicles tax, entertainment tax, electricity duties and other taxes and duties.

NON-TAX REVENUE

The non-tax revenues of the Union Government contain (A) Administrative receipts (B) net contribution of public sector undertakings; (i) Railways (ii) Posts and Telegraphs (iii) Currency and mint and (iv) others. (C) Other revenues which contain revenue from forests, opium, irrigation, electricity and dividends due from commercial and other undertakings.

Administrative receipts contain state plan loans advanced to states through the Centre. In pursuance of the recommendations of the Ninth Finance Commission as accepted through the government, the state plan loans advanced to states throughout 1984-89 and outstanding as at the end of 1989-90 have been consolidated for 15 years with 9% rate of interest. The interest receipts from the state governments are estimated at Rs. 5,576.53 crore in the revised estimate of 1990-91 and Rs. 6,789.5 crore in the budget estimate of 1991-92.

	Interest receipts, Dividends and Profits	(in Rs. Crores)	
	Budget	Revised	Budget
	1990-91	1990-91	1991-92
a) Interest Receipts	9,519.09	9,572.74	11,008.82
b) Dividends and Profit	720.89	779.55	967.12
	10,239.98	10,352.29	11,975.94

Interest on Loans to Union Territory Governments: The interest receipts throughout 91is estimated at Rs. 16 crores and Rs. 18.71 crore in budget estimates of 92 on loans advanced to Union Territory of Pondicherry. Interest payable through Railways: In conditions of the recommendations of the successive Railway Convention Committees (RCC) of Parliament, the Railways paid a fixed dividend to General Revenues on the capital invested in the Railways as computed annually.

Other Interest Receipts: The estimates under ‘other interest receipts’ are in respect of interest on loans advanced to public sector enterprises, port trusts and other statutory bodies, cooperatives etc. and on capital outlays on departmental commercial undertakings.

Table
International Financial Institutions

	Receipts	Budget 1990-91 Discharge	Net	Receipts	Revised 1990-91 Discharge	Net
1) International Monetary Fund	509.40	0.05	509.35	549.98	326.18	223.80
2) International Bank for Reconstruction and Development	115.77	14.00	101.77	115.77	18.00	97.77
3) International Development Association	_	0.60	(-) 0.60	0.00	0.60	-0.60
4) International Fund for Agriculture	4.49	1.85	2.64	4.49	1.85	2.64
5) Asian Development Bank	—	0.10	(-) 0.10		0.40	(-) 0.40
6) African Development Fund and African Development Bank	7.44	4.80	2.64	7.44	4.70	2.74
Total	637.10	21.40	615.70	677.68	351.73	325.95
S.D.	1,250.17	1,033.73	216.44	2,736.26	2,562.35	173,91

As a result of evaluation of Fund's holdings of Indian currency as on April 30, 1991 the budget estimates for 1991-92 give Rs. 1,805.03 crore as expenditure for this purpose with corresponding credit under securities account. India is a participant in the Special Drawing Rights (SDRs) Department of the IMF. Throughout the year 1990-91 the net cumulative allocation of SDRs to India remained at SDR 327.00 million as there was no fresh allocation of SDRs. As in the case of Union Government, the non-tax revenues of the state governments contain administrative receipts, net contribution of the public sector undertakings grants-in-aid and other contributions. /

SHARING OF RECEIPTS WITH STATES

Indian Constitution is quasi-federal and the country has a three-tier government, the central government, the state governments and the local governments. As the local public authorities are directly under the state government, no separate allocation of taxation rights has been done to them. To avoid any dispute flanked by the centre and states in the fields of taxation, the following constitutional provisions have been made.

- There is no tax which can be levied through both the centre and the states. The custom duties and the corporation tax fall within the purview of the central government and they account for about 50% of its tax revenue. States have power to levy some other taxes to finance their activities. The significant taxes falling in this category are sales tax, land revenue, state excise duties, entertainment tax etc.

- Some taxes are levied through the central government but their proceeds are divided flanked by the centre and the states. Union excise duties and taxes on income other than agricultural income belong to this category. The basis on which these taxes are divided flanked by the centre and the states is recommended through the Finance Commission.
- The power to levy and collect sure taxes is vested in the centre, whereas their revenue proceeds are to be distributed in the middle of the states. Estate duty on property other than agricultural land, duty on railway freights and fares, terminal tax on goods and passengers accepted through railways.

Though some taxes are levied through the central government, the responsibility to collect them is on the state government. For instance, stamp duties other than those incorporated in the Union list and excise duties on drugs and cosmetics have been incorporated in this category. There is need for decentralization of functions for encouraging local initiative, for securing promptness in decision-creation and efficiency in its implementation, and for allowing for a diversity of experiments to suit varying needs, tastes and temperaments this is implied in the federal nature of the Constitution which ensures immediate effective resource mobilization and maintenance of national perspective.

According to 1991-92 budgets, current situation of sharing of receipts with states is as follows:

Table
Tax Revenue

	Budget 1990-91	Revised 1990-91	Budget 1991-92
Total Tax Revenue	59,778.57	58,916.01	66,217.73
Less states share:			
Taxes on income	4,064.31	4,120.48	4,467.91
Union Excise Duties	10,361.44	10,414.00	11,175.47
Total States Share	14,425.75	14,534.91	15,643.38
Less : Transfer of Union territory taxes and and duties to local bodies	58.83	63.25	79.43
Centre's Net Tax Revenue	45,293.99	44,317.85	50,494.92

There exists a disagreement flanked by the transfer of finances made in accordance with the Finance Commission's recommendations and that of Planning Commission. To avoid this, Finance Commission should be recognized as a permanent statutory body. Its scope and functions necessity be widened through appropriate constitutional amendments. The devolution of revenues from centre to states should be in conventionality with economy, administrative convenience and efficiency. It should be able to give national minimum to people. The ideal way of achieving this is to transfer possessions from richer to poorer states. While transferring possessions to states, population, climate and rainfall, state of economic development should be kept in mind.

Central Government should not create directly any loans to states. State Governments should be encouraged to borrow directly from the public as much as they can. A significant development in the sphere of centre-state financial relations in the recent years relates to the states taking recourse to unauthorized overdrafts with the RBI. Two factors, namely, temporary difficulties because of the uneven flow of receipts and expenditures and chronic imbalances flanked by their functions and possessions have been behind this trend. Of late repayment of and interest on debts falling due every year are causing a great drain on the state governments' budgetary possessions. Mainly of the projects on which the state governments invested capital through borrowing from the centre are not yielding the desired rate of returns. This calls for more determined efforts to improve the performance of public sector projects. But some of the non-plan loans have become dead weight debts which need to be remitted. Centre-state financial relations need review and readjustment. States should learn to live within their means and should use their possessions fully.

RESOURCE MOBILISATION OVER THE YEARS

India has done very well in conditions of tax effort. In 1950-51 when the planning procedure was initiated, the Tax-Net National Product (NNP) ratio was as low as 6.4%. Since then it has been rising steadily and stands at 25% (almost) today. For a developing country like India which started its development effort with a very low per capita income and has recorded a very modest rate of growth (i.e. around 7o per annum augment in NNP per capita), this record in mobilizing tax revenue is extraordinarily good through any standard. In India all the major taxes, except personal income tax and land revenue, have recorded buoyancy greater than unity. In recent years buoyancy of excise duty and sales tax has been as high as 1.51 and 1.41 per cent respectively. This has enabled far greater mobilization of possessions through taxation. There still remains some scope for raising additional tax revenue in the country. This can be done if the government decides to show the required political will to tax agricultural incomes which presently remain outside the taxation net.

Separately from tax revenue other significant characteristics of resource mobilization are generation of non-tax revenues, restricting of current government expenditure and raising of surpluses of public sector enterprises. Additional resource mobilization measures undertaken in the 1990-91 budgets were expected to yield Rs. 1,790 crore. Out of this Rs. 550 crore were to be raised through direct taxes and Rs. 1240 crore through indirect taxes. The states' share in centre's additional resource mobilization after creation adjustment for the loss of Rs. 170 crore on account of concessions in income tax was estimated at Rs. 3 crore.

The Railway Budget for 1990-91 proposed hikes in the rates of goods traffic, passenger fares, parcel and luggage rates. These proposals are estimated to yield additional revenue of Rs. 892 crore. Revision in the postal and telecommunication tariffs were estimated to result in additional revenue of Rs. 645 crore. The total additional revenue changes in tax rates, through revisions in railway fares and freights and through revisions in postal and telecommunication tariffs was therefore estimated at Rs. 3327 crore in 1990-91.

Net profits (after tax) of central government public enterprises increased considerably from Rs. 2994 crore in 1988-89 to Rs. 3782 crore in 1989-90. The rate of return, as measured through the ratio of net profits to capital employed, rises to 4.5% in 1989-90, which is the highest achieved in the decade. Though the petroleum sector accounted for the bulk of these profits, i.e. Rs. 2,900 crore but of the total Rs. 3,782 crore in 90. The non-petroleum sector enterprises numbering about 200 contributed a meager sum of Rs. 882 crore. While this reflects an improvement over the net profit of Rs. 430 crore made in 1988-89, the ratio of the net profits to capital employed in non-petroleum sector enterprises was only 1.3% in 1989-90. It designates that there is a substantial scope for improving the financial performance of non-petroleum central government public enterprises. The overall working results of Central Government public enterprises for the first half of 1990-91 showed a net profit of Rs. 481 crore as against Rs. 1,103 crore throughout the corresponding period of 1989-90.

The seventh plan envisaged generation of internal possessions to the extent of Rs. 23,013 crore and additional resource mobilization to the extent of Rs. 11,490 crore at 1984-85 prices for financing the plan outlays. Against this throughout the seventh plan, the public enterprises have generated gross internal possessions of Rs. 37,715 crore at current market prices. About 32% of plan investment in central public enterprises throughout the seventh plan was financed through generating net internal possessions 28% through extra-budgetary possessions and 40% through the budgetary support. The outlook on the resource mobilization front is serious but not unmanageable. The resource imbalances accumulated over man-years cannot be eliminated in a short period. In the present context soft options have either a limited effect or no effect at all in the correction of macro-economic imbalances. The measures introduced throughout 91, which aimed at better revenue collections and containment of public expenditure have had a limited effect as evidenced through the revised budget deficit which is estimated to be considerably higher than the budget estimate. It is essential that a serious effort be made to introduce corrective measures through hard decisions and hard choices. Any beginning should aim at strict control over government expenditure, particularly the revenue and non-plan expenditure, rationalization of subsidies so that they are better directed towards the poor and improvement in revenue collections. Sustained effort on the part of the government may give the basis for a transition to a sustainable resource regime over the after that few years.

REVIEW QUESTIONS

- Explain the significant elements of public debt management.
- Discuss the role of deficit financing as an aid to financing economic development.
- What do you understand through direct taxes? State the kinds of direct taxes levied through the Union Government?
- What is Corporation Tax?
- Distinguish flanked by specific and ad valorem excise duties.

CHAPTER 5

INVESTMENT OF PUBLIC FUNDS

STRUCTURE

- Learning objectives
- Economic and social appraisal
- Financial appraisal
- Review questions

LEARNING OBJECTIVES

After reading this unit, you should be able to:

- Highlight the need for an economic analysis through governments.

- Discuss the role of Cost Benefit Analysis in project development, evaluation and implementation.
- Bring out the differences flanked by financial and economic analysis.

ECONOMIC AND SOCIAL APPRAISAL

ROLE OF COST BENEFIT ANALYSIS IN PROJECT DEVELOPMENT, EVALUATION AND IMPLEMENTATION

The techniques of financial and cost benefit analysis are employed in three of the six identifiable stages of project formulation and evaluation viz., 2, 3 and 6 given below: At this stage, the initiating agency, such as a government department or utility, defines the initial concept of project and outlines the objectives that the government wishes it to achieve. These may contain the provision of health, transport or education services, for instance. The first major issue that necessity be investigated is the subsistence of market opportunities. In the case of social services, the analyst necessity determine the anticipated demand for the project's output and the benefits that the public is expected to derive from these services. An initial assessment of the best technology to employ, given local factor prices, as well as the appropriate scale and timing of the project is also necessary. Engineers, health specialists, educationalists, environmental scientists, agricultural specialists, market analyst and several other professionals will contribute to this stage of the project's development. Economists may also be involved in a preliminary assessment of the viability of alternative technology given the relative prices of capital and labour in the country concerned. This procedure yields the basis concept of the project and background information, which enables the government to progress to the pre-feasibility revise stage.

Pre-feasibility Revise

At this stage, the analyst obtains approximate valuations of the major components of the project's costs and benefits: input and output quantities and prices. More precise estimates necessity be made of the demand for the project's output, the technical capability and cost of the plant or technology envisaged, and the project's manpower necessities. In several cases this data will be provided through the technical professionals involved in the original project identification stage. Using this preliminary data, financial and economic analyses of the project will then be undertaken through the economic analyst, to determine whether the project appears to be financially and economically viable. A preliminary financing schedule may also be drawn up to identify the source and costs of funds. If the project appears viable from this preliminary investigation, it will be worthwhile proceeding to the full feasibility revise stage.

Feasibility Revise

At this stage, more accurate data necessity be obtained on all project costs and benefits, but particularly those that risk analysis designates are crucial to the project's viability. The financial and economic viability of the project is then assessed again. If the project is still found to be viable, approval should be sought to proceed to the project design stage.

Project Design

This involves undertaking the detailed engineering design work of the project, based on the technology envisaged at the feasibility stage. Manpower necessities, administration and marketing procedure are all finalized at this point.

Implementation

At this stage, tenders are let and contracts signed to facilitate the appointment of the project manager, who will oversee the construction and perhaps the operation of the project.

Ex-post Evaluation

The final stage of a project is essential, yet regularly overlooked in project appraisal and implementation. This evaluation is intended to determine the actual contribution that the project has made to national welfare, after man-years of project operation. Its primary purpose is to help to identify the major sources of project success and failure, so that future project development, analysis and operation procedures can benefit from past experience.

FINANCIAL ANALYSIS AND ECONOMIC ANALYSIS: DISTINCTION

The economic analysis technique outlined above have much in common with financial analysis. Though there are important points of distinction.

- Firstly, a traditional financial analysis examines a project from the narrow perspective of the entity undertaking the project. It does not take account of effects on other enterprises or individuals. Therefore, a proposal put forward through one government agency may inflict costs (or confer benefits) on other government agencies, on private sector enterprises or on individuals. These external costs and benefits necessity be taken into account. Likewise, a strictly financial analysis does not consider the opportunity cost of using possessions in the case where the actual price paid through or to the entity is not a good indicator of the real value in conditions of alternative uses.

- Secondly, economic evaluation does not consider directly the payment of interest. Rather real resource flows are shown and time preference is taken into account through the use of a discount rate.
- Thirdly, in economic analysis capital expenditure is recognized as a resource cost at the time it is incurred whereas in financial analysis it may be shown amortized over the life of the project for taxation and other purposes.

In the public sector the fundamental requirement is for an economic appraisal. Though it should be noted that the undertaking of an economic appraisal does not remove the need for a financial analysis. The financial analysis will show the demands on cash flow which will result from the project- a significant factor when managing the State's finances. It will also show the rate of return from the project which is significant for commercial agencies. There is a significant distinction flanked by the costs and benefits involved in a financial analysis and those incorporated in an economic analysis.

Financial analysis whether used in the public or the private sector, implies the notion of the agency maximizing its net financial surplus over time. This will usually differ from the maximization of the economic surplus generated for the community as a whole whenever prices do not reflect the benefits or costs associated with an activity (in some case there may not even be any prices because benefits and costs are not traded).

In the case of the more commercial agencies the differences flanked by financial appraisal and economic evaluation will commonly be comparatively small. Though for agencies with important community service obligations, financial appraisal can be suitably applied only in a narrow range of decision choices. Therefore in the economic evaluation of a public road not subject to a toll, financial appraisal will not be of much assistance. Likewise, in choosing flanked by two sites for a hospital, not only should the costs of structure on the two sites be measured, but also the stage of transport costs and length of travel time incurred through patients and visitors to the hospital. Therefore in estimating the economic costs and benefits of a project, the analyst will have to estimate values where no direct price is charged and will usually have to consider a wider range of costs and benefits than occurs in a financial appraisal.

STEPS IN PREPARING A FULL ECONOMIC EVALUATION

The steps in preparing a standard economic evaluation are outlined below:

- Definition Objectives: The starting point and in several ways the mainly crucial characteristic for the evaluation of an investment proposal is the specification of the objectives of the proposal and their relation to the overall objectives of the agency. No appraisal of the project can be meaningful unless the objectives are clearly defined.
- Identification Options: It is necessary to identify the widest possible range of options at the earliest stage of the planning procedure. One alternative that should be measured is the possibility of the objective being met through the private sector. In developing several options the first option to be measured is the base case of "do nothing" i.e. retain the status quo. This is not to say the base case will not involve costs; in several cases doing nothing (for instance continuing with a low maintenance programme) will result in cost penalties. One benefit of doing something may be the avoidance of these costs. In the case of asset replacement decisions it may involve deferral of replacement and sustained maintenance and or eventual replacement with a new asset of comparable standard to that being replaced. In the case of an expansion of activities the base case would represent a continuation of the existing system or policies.
- Identification of Costs and Benefits-The With-Without Principle: This is the vital principle of any kind of project evaluation. In practice, it means that an attempt should be made to estimate the "the state of the world" as it will exist with the project in subsistence. This should be contrasted with the "state of the world" that would have existed in the absence of the project (the "do nothing" option).

This principle has two significant implications:

- First, economic evaluation necessity not basically be a comparison of before project circumstances with after project circumstances because such comparison would attribute the contribution of all pre-existing trends and external factors to the project itself For instance, reductions in on-going costs due to changed work practices should not be attributed to savings from an investment in new plant if the changes in work practices would have been introduced regardless of the investment decision.
- Second, the analysis should contain all impacts, both beneficial and otherwise, of the proposal being evaluated. In scrupulous, not only should the planned effects or benefits which are the objectives of the project be incorporated, but also the subsidiary or indirect effects.

There are a range of kinds of benefits and costs which necessity be measured, and they accrue to dissimilar people: some accrue directly to the user or provider of the service; while others accrue to outsiders (these are recognized as externalities). The case of the evaluation of a dam whose primary purpose is the provision of irrigation for commercial crops can be used as an instance. The impacts to be incorporated in the analysis would be:

- The provision of irrigation water for cropping (the primary objective and a traded benefit);
- The provision of urban water (a traded benefit)
- Flood mitigation benefits (a quantifiable non-traded benefit which is external to the users and providers of water);
- Recreational benefits offered through the dam (a quantifiable non- traded benefit external to the consumers of water); and
- Environmental effects on native flora and fauna (an external effect which may be hard to quantify even in physical conditions).

The importance of the with-without principle cannot be overstated. Failure to adopt it may lead to meaningless results.

- Valuation of Costs and Benefits: When considering how impacts should be valued in practice, it may be convenient to classify impacts into three categories.
    - Costs and benefits which can be readily recognized and valued in money conditions (e.g. Value of additional electricity supplies to users, travel time savings).
    - Effects which can be recognized and measured in physical conditions but which cannot be easily valued in money conditions because of the absence of market signals and consequential disagreement as to the rate of valuation (e.g. museums, reduction in pollution).
    - Impacts which are recognized to exist but cannot be precisely recognized and accurately quantified, let alone valued (e.g. Crime prevention effects of police programs, comfort improvements in new trains, aesthetic effects of beautification programs).

When considering benefits and costs which either cannot be valued or cannot be quantified there can be a tendency to concentrate on the benefits and ignore the costs. This should be resisted. Where valuation is possible, two key concepts need to be kept in mind.

- The Opportunity Cost Principle: The use of possessions (manpower, finance or land) in one scrupulous area will preclude their use in any other. Hence the basis for valuing the possessions used is the “opportunity cost” of committing possessions; i.e. the value these possessions would have in the mainly attractive alternative use.
- The adoption of this principle reflects the fact that the economic evaluation of public sector projects should be mannered from the perspective of society as a whole and not from the point of view of a single agency.
- Commonly, the price paid for new capital, labour or inputs will reflect the opportunity cost of the possessions. The position may be less clear in the case of the existing land owned through the agency. Though, in general it is measured that a cost equivalent to its maximum market value or likely land use zoning should be placed on such land.

- The general principle applies even where the public sector may have access to an input at a cost dissimilar from its market value. For instance, coal supplied from an electricity generator's own collieries should be priced at the market price for comparable coal rather than the costs of supply, reflecting the fact that the coal has an alternative use.
- Willingness-to-pay Principle: In valuing the benefits of a project the aim is to place a monetary value on the several outputs of the project. Typically such outputs will contain:
    - Benefits for which a price is paid; and
    - Benefits for which no price is paid.

Where the services are bought and sold it is usually presumed that the price paid is a reasonable proxy for the values of the service to the consumer. This principle will hold mainly closely where the changes in output and price stages associated with the investment are relatively small. Where output changes are important then it may be desirable to take account of changes in consumer surplus (an excess over the market price which the consumer would have been willing to pay). This will require knowledge of the price elasticity of demand (i.e. sensitivity of demand to changes in price). Though, where the service is not freely traded or there is no price charged, or where the benefits fall broadly on the community rather than individual users, more indirect measures of the willingness to pay for the benefits need to be derived. A diversity of techniques are accessible including:

- The use of data on expenditure through consumers in seeking to participate in benefits (e.g. Costs incurred in visiting a national park);
- Price data from related goods and services (e.g. Variations in house prices due to the impact of noise stages to assess the cost of airport noise); and
- Choice experiments (e.g. experimental choice flanked by a diversity of existing and new amusement/recreation amenities to infer a value for a new amenity).

Where no recognized framework exists, valuation of non-traded outputs will have to be approached on a case through case basis. Some government services have been provided at subsidized prices and this introduces distortions in the market. So the imposition of customer charges to value benefits is likely to understate benefits. As with services for which no price is charged, additional effort is needed in the appraisal to estimate the additional benefits, either from externalities or consumer surplus.

Specific Issues

Avoidance of Double Counting or Overstating of Benefits

In enumerating the costs and benefits of a proposal, care should be taken to avoid double counting. For instance, the construction of a dam may augment the value of the land which is to be irrigated as a result of the increased skill of the land to grow crops. The increased value of the land merely reflects the market's capitalization of the increased output stream. Inclusion of the net value of the increased output and the increased land value would count the same benefit twice.

Another danger is the overstatement of benefits through attributing the total output of a procedure to a single input. In the above instance, the total value of the crops made accessible through the water irrigation project should not be attributed to the project. Rather the net value of the additional production should be derived through deducting all additional input costs from the value of the additional output, i.e. the costs of labour, capital and other inputs such as fertilizer and fuel should be deducted from the value of the output. Measured in this way the value of net output, subject to provision for a normal profit gives a measure of the willingness to pay for water. Hence, the inclusion of this benefit would also require adjustment for actual payments made for water provided.

Treatment of Inflation

Due to inflation, costs and benefits which occur later will be higher in cash conditions than similar costs or benefits which occur earlier. There are two dissimilar ways to tackle this issue. Either nominal values can be used for each time period and then discounted with a nominal discount rate, or real cash flows can be used discounted through a real discount rate. In practice it is measured that the use of real cash flows and discount rates may simplify the forecasting and calculation processes.

Use of Shadow Prices

A shadow or accounting price is the price that economists attribute to a good or factor on the argument that it is more appropriate for the purpose of economic calculation than its existing price, if any. In evaluating any project, the economist may effectively correct a number of market prices and also attribute prices to unprimed gains and losses that it is expected to generate. He will, for instance, add to the cost of a factor or subtract from the cost of a good, in creation allowance for some external diseconomy. Wherever the amounts of a good, to be added to or subtracted from the existing consumption are large enough, the economist will substitute for price the more discriminating measure of benefit, consumer surplus. Sure gains or losses to an enterprise he will value as zero, since for the economy at large they are only transfer payments. The cost of labour that would otherwise remain idle, he necessity value at its opportunity cost; not at its wage; and so on.

Valuation of Specific Cost Items

- Land and Pre-existing Structures/Plant: While a project may use land, structures or plant already owned through an agency for which no payment will be made, the opportunity costs of these assets should be incorporated.
- Labour: In assessing labour costs, the value of existing labour possessions transferred to the project, as well as additional labour required, should be incorporated.
- Overheads: Labour related overheads such as supervision, transport costs, administrative costs, printing and stationery etc., are also incorporated.
- Residual Values: At the end of the planning horizon or project life, some assets may still have some value. Such assets may not have reached the end of their economic life and may still be of use to the agency or may be resale able. In this case the value of an asset may be assessed at a stage pro rata to its remaining economic life. Alternatively the asset may have reached the end of its economic life but have a scrap value. This value is a benefit to the project and should be incorporated in the evaluation. Sure assets are non-depreciable, such as land and can be valued at opportunity cost.

Costs to be Excluded from Analysis

A number of items which are incorporated as costs in accounting reports or financial appraisals should not be incorporated in an economic evaluation of an investment proposal.

Sunk Costs

In an evaluation, all costs necessity relate to future expenditures only. The price paid 10 years ago for a piece of land or a plant item is of no relevance; it is the opportunity cost in conditions of today’s value (or price) which necessity be incorporated. All past or sunk costs are irrelevant and should be excluded.

Depreciation

Depreciation is an accounting means of allocating the cost of a capital asset over the years of its estimated useful life. It does not directly reflect any opportunity cost of capital. The economic capital cost of a project is incurred at the time that labour, machinery and other inputs are used for construction, or in the case of an existing asset, when it diverted from its current use to use in the project being evaluated. These project inputs are valued at their opportunity cost. Hence, depreciation should not be incorporated in the economic evaluation.

Interest

As future cash flows are discounted to present value conditions in economic evaluations, the choice of the discount rate is based on several factors which contain the rate of interest. The discounting procedure removes the need to contain interest rate in the cash flows.

Discounting of Future Costs and Benefits

The Concept of Discounting

The costs and benefits flowing from an investment decision are spread over time. Initial investment costs are borne up front while benefits or operating costs may extend far into the future. Even in the absence of inflation, a rupee received now is worth more than a rupee received at some time in the future. Conversely, a rupee's cost incurred now is more onerous than a rupee's cost accruing at some future time. This reflects the concept of time preference which can be seen in the fact that people normally prefer to receive cash sooner rather than later and pay bills later rather than sooner. The subsistence of real interest rates reflects this time preference.

In order to compare the costs and benefits flowing from a project it is necessary to bring them back to a common time dimension. This is done through discounting the value of future costs and benefits in order to determine their present value. The procedure of discounting is basically compound interest worked backwards.

The Recommended Discount Rate

Private sector entities sometimes require that the rate of return on a scrupulous project exceeds the return expected on an alternative project which might otherwise be undertaken. Or they might stipulate a return somewhat in excess of the cost of borrowed funds. Public sector decision-makers will be encouraged to invest in projects which generate returns greater than the government's test discount rates. Three alternative bases for the setting of the discount rate have been proposed:

- Social time preference;
- Opportunity cost of capital; and
- Cost of funds.

The first two concepts of the discount rate relate to the opportunity cost of the possessions used in the public sector investment projects. Possessions could be used elsewhere and the discount rate attempts to measure such opportunities foregone. In principle the social time preference rate and the opportunity cost of capital should be the same. Though, for several reasons such as private sector profit and capital constraints in the public sector, the two will differ. Typically the opportunity cost of capital will be greater than the social time preference rate.

Possessions devoted to public investment will be at the expense of current consumption or private sector investment. In a rising economy with rising living standards, a rupee's consumption today will be more valued than a rupee's consumption at some future time for, in the latter case, the rupee will be subtracted from a higher income stage. This so-described marginal social rate of time preference is, of course, not easy to measure. If alternatively, public investment takes place at the expense of private investment then, from an economic efficiency viewpoint, public investments of an economic nature should not be sanctioned if they are expected to earn significantly lower rates of return than those same possessions might earn (before tax) in the private sector (the so-described marginal social opportunity cost).

This concept is also hard to measure accurately. The concern is not with the average rate of return in the private sector, but with the marginal rate - that is with the rate which would be earned through the private sector if additional capital allowed further private investment to occur. In theory a perfectly competitive capital market will see equality of the consumer's marginal rate of time preference, the investor's rate of return on the marginal project and the market rate of interest. In practice interest rates give limited guidance to the estimation of discount rates on these bases. In the face of the difficulty of measuring discount rates on these bases, it has sometimes been argued that the appropriate rate of return or discount rate should be derived from the interest rate at which government borrows funds in the market. But given the dominant position of government in the capital market, the variability of interest rates and the wide range of factors which impact on interest rates this is quite an inadequate way of deriving the appropriate discount rate.

Impact of Discount Rates on Project Ranking

It should be noted that the choice of the discount rate is an significant issue as it can have a important impact on the ranking of options/projects and hence their choice. In general, as the discount rate rises projects with larger initial outlays and lower ongoing outlays become relatively less attractive compared with projects with lower initial outlays and higher ongoing outlays. Therefore, a higher discount rate would favor maintenance options as against asset replacement. Likewise in the case when net benefits are spread far into the future, the higher the discount rate, the more net benefits far in the future are downgraded in present value conditions relative to net benefits closer to hand. Therefore, short lived options are favored through higher discount rates relative to long-lived options.

Decision Criteria

Once all the costs and benefits over the life of the programme have been recognized and quantified, they are expressed in present value conditions. Using the discounted stream of costs and benefits, the following decision measures should be calculated. Investment decision creation is primarily concerned with three kinds of processes:

- The screening procedure, whereby the decision maker, faced with a range of independent projects and adequate possessions, necessity accept or reject the individual projects.
- The choice procedure flanked by mutually exclusive projects, whereby the decision makers necessity choose from a range of mutually exclusive projects (commonly directed at similar objectives):
- The ranking procedure, whereby the decision maker is faced with resource constraints which prevent all acceptable projects from being preceded with-hence the projects necessity be ranked in an objective manner.

Several investment criteria are accessible in reaching decisions in these circumstances. Commonly used criteria are the Net Present value (NPV); Internal Rate of Return (IRR), Benefit Cost Ratio (BCR) and Net Present Value per constrained unit of input (NPV/I).

Net Present Value

Net Present Value is the sum of the discounted project benefits less discounted project costs. Formally it can be expressed as follows:

$$NPV = \sum_{n=0}^{N} \frac{B_n - C_n}{(1+r)^n}$$

Where B_n = project benefits in year n expressed in constant rupees
C_n = project costs in year n expressed in constant rupees
r = real discount rate
N = number of years that costs and/or benefits are produced

Under this decision rule, a project is potentially worthwhile (or viable) if the NPV is greater than zero; i.e. the total discounted value of benefits is greater than the total discounted costs. If projects are mutually exclusive, the project which yields the highest NPV would be chosen.

Benefit-Cost Ratio

The Benefit-Cost Ratio (BCR) is the ratio of the present value of benefits to the present value of costs. In algebraic conditions it can be expressed as follows:

$$BCR = \sum_{n=0}^{N} \frac{B_n}{(1+r)^n} / \sum_{n=0}^{N} \frac{C_n}{(1+r)^n}$$

A project is potentially worthwhile if the BCR is greater than 1; i.e., the present value of benefits exceeds the present value of costs. If projects are mutually exclusive, this rule would indicate that the project with the highest BCR should be chosen. It has become conventional to split costs into two kinds when calculating BCRs: initial capital costs and ongoing costs. Ongoing costs are normally deducted from benefits in the year incurred to create a net benefit stream, while initial capital costs are used as the denominator.

Internal Rate of Return

The Internal Rate of Return (IRR) is the discount rate at which the net present value of a project is equal to zero, i.e. discounted benefits equal discounted costs. In algebraic conditions the IRR is the value of r which solves the equation:

$$0 = \sum_{n=0}^{N} \frac{(B-C)_n}{(1+r)^n}$$

A project is potentially worthwhile if the IRR is greater than the test discount rate. If projects are mutually exclusive, this rule would suggest that the project with the highest IRR should be chosen.

Evaluation of Decision Rules

The NPV and BCR give equally acceptable criteria for showing whether an individual project is worthwhile, when taken in isolation. Both clearly show when, for a given discount rate, the project benefits exceed costs and the results of the rules will not disagreement with each other. While in several cases the IRR will also yield simple and unambiguous results, care needs to be exercised in the use of IRR. In cases of non-conventional cost-benefit streams (i.e. where there are substantial discontinuities or breaks in the net benefits stream over time) more than one quite dissimilar IRR may be calculated. An instance of a non-conventional cost-benefit stream is where a project incurs net costs initially followed through net benefits over a number of years and then net costs again.

Choice flanked by Mutually Exclusive Projects

A simple use of NPV, BCR and IRR will not yield the same results for the more complex choice flanked by mutually exclusive projects. The project with the highest NPV may not have the highest IRR or the highest BCR. In the latter case this is because the ratio can be affected through the inclusion of costs as negative benefits, or dissimilar balances flanked by initial costs and ongoing costs. This creates it hard to compare crossways projects.

Where there are no constraints on inputs, such as capital possessions, the choice flanked by projects should be made on the basis of maximization of NPV; i.e. the project with the highest NPV should be preferred. This will ensure that the project which gives the largest potential contribution to welfare is adopted.

Ranking Under Constraints

In practice decision-makers operate in environments where constraints are commonplace. Indeed constraints on capital funds are approximately universal. In order to ensure the Government's budgetary objectives are met, such constraints will clearly heavily influence decision creation on projects. The problem facing decision-makers is to rank projects in conditions of return to the constrained input and then choose projects so as to maximize the NPV of the total program. None of the three decision criteria discussed above take capital constraints explicitly into account, although the BCR calculation as indicated above implicitly does so. Though, use of the NPV per rupee of total capital would result in the choice of that combination of projects which maximizes the total NPV obtained from a limited capital works budget. It can be readily calculated as follows:

$$NPVI = \sum_{n=0}^{N} \frac{(B-C)_n}{(1+r)^n} \Big/ \sum_{n=0}^{N} \frac{I_n}{(1+r)^n}$$

Where I_n = capital investment in the project in year n

$C_n = I_n$ + Operating costs in year n

Note that the capital investment is discounted to its present value in the same way as are the net benefits. Using this measure, projects with the highest NPV per dollar of total capital are selected until the budget is exhausted. This means that the expenditure constraint may be a factor in the choice of an investment option which does not have the highest NPV, if the option with the highest NPV requires very high expenditure. In such circumstances the return on the incremental expenditure may be relatively low. This procedure seeks to maximize aggregate NPV from the accessible funds.

Sensitivity Analysis

Sensitivity Analysis is used to assess the possible impact of uncertainty. It illustrates what would happen if the assumptions made about some or all of the key variables proved to be wrong and shows how changes in the values of several factors affect the overall cost or benefit of a given investment project. A key practical role of sensitivity analysis is to incorporate dissimilar views about one or more key assumptions which can reasonably be held through the dissimilar people involved in the assessment procedure.

It is a useful means of indicating the critical elements on which the outcome of the project depends. This allows management to focus on these areas throughout project implementation or to divert further possessions to the improvement of cost and benefit estimates and the reduction of uncertainty. (It is a necessary part of any investment appraisal.)

Post-Implementation Review

A selection of the major projects undertaken through an agency should be subject to ex-post evaluations. In addition, major ongoing programs which may involve a series of smaller projects should be subject to such ex-post evaluations. These evaluations would involve:

- Re-evaluation of the benefits and costs of the selected option to assess whether the anticipated benefits were realized and the forecast costs kept to;
- Reconsideration of alternative options; and
- Examination of the project design and implementation to assess the scope for improvement to the option adopted.

Through examining these issues ex post evaluations will assist in the development and evaluation of future projects. In addition, public sector agencies should implement procedures for ongoing asset management and assessment.

SOCIAL COST BENEFIT ANALYSIS

The financial or traditional economic project appraisals implicitly assumed that income sharing issues are beyond the concern of the project analyst or that the sharing of income in the country is measured appropriate. Though, in several, if not mainly, developing and developed countries governments are not only interested in rising efficiency but also in promoting greater equity. In mainly countries the existing sharing of income is clearly not measured to be ideal through the government or the population. Social cost benefit analysis or the social appraisal of project has evolved to respond to this need.

A social appraisal of a project goes beyond an economic appraisal to determine which projects will augment welfare once their sharing impact is measured. The project analyst is not only concerned to determine the stage of a project's benefits and costs but also who receives the benefits and pays the costs. Social appraisal so tackles the moral and theoretical dilemma-which a project is worth undertaking if it has the potential to produce a Pareto improvement in welfare.

In an economic analysis of a project it is implicitly assumed that a dollar received through any individual will augment the community's welfare through the same amount as a dollar received through any other individual. Though, an extra dollar given to a very poor person, with an annual income of say only USD300, will usually augment that person's welfare through much more than would a dollar given to the same person if he or she became very rich, with an annual income of USD 100000. As a society we may be prepared to undertake a project, A, which increases the consumption of poor people through USD 100 per annum even if it reduces the consumption of rich people through USD50. On the other hand, the community may not be prepared to undertake another project, B, which increases the consumption of the rich through USD 100 and reduces that of the poor through USD50. The theoretical rationale in welfare economics for the social analysis of projects is so quite strong, as the marginal utility of income of a person who receives a low income is expected to be greater than the marginal utility of income of the same person if she or he receives a high income. An economic analysis of projects A and B would not capture these differences and would merely indicate that both had the same positive impact on community welfare.

Distributional Weights

One of the mainly commonly used methods of undertaking a social cost benefit analysis is to introduce distributional weights in to the cash flow. Distributional weights are attached to changes in income, costs and benefits, received through dissimilar income groups, ensuring that a project's impact on the income of low income groups receives a higher weight than the same dollar impact on the income of high income groups. The introduction of these distributional weights enables projects to be assessed on the basis of distributional as well as efficiency objectives.

The Introduction of Distributional Weights into the Cash Flow

In an economic analysis, project generated changes in consumption enjoyed through all income groups are weighted at unity, d=l. In a social analysis income accruing to (or being taken from) lower income groups would typically be given a distributional weight greater than one (d>l). On the other hand, income accruing to (or being taken from) a high income group would be given a weight less than one (d<l). A project that benefits a low income group would so have a higher social net present value than one that benefits a high income group, if all other, un-weighted costs and benefits remain the same. In the instance shown below the government of a country with a highly skewed income sharing is considering two mutually exclusive projects, A and B.

	Poor	Table 1	**Rich**	**Poor**		**Rich**
Cost paid by	0		100	80		0
Benefits received by	150		0	0		160
If distributional weights, d:	1		1	1		1
Economic NPV		+50			+80	
Therefore do Project B						
If distributional weights, d:	2		1	2		1
Cost paid by	0		100	160		0
Benefits received by	300		0	0		160
Social NPV		+200			0	
Therefore do Project A						

Project A's costs are borne through the rich and its benefits are received through the poor, while project B is the opposite. Its costs are borne through the poor and its benefits are received through the wealthy. Since the two projects are mutually exclusive the project wit the highest NPV should be selected. If an economic analysis were undertaken and distributional weights of unity were applied to the costs and benefits of the two projects, project B would have an NPV of $L80 and project A an NPV of $L50. Hence, project B should be selected. Though, if the government decides that it values income going to the poor more highly than income going to the rich and applies a distributional weight of, for instance, d=2 to the low income group's income, project A would have a social NPV of $L200 and project B would have a social NPV of $L0. Project A would then be selected on the basis of a social cost benefit analysis.

Arguments for and Against the Use of Distributional Weights

There are many troubles for analyst wishing to use this approach. The first is the difficulty of tracing the net income changes accruing to dissimilar income groups as a result of the project, even in the case of relatively straightforward project. It may be very time consuming and expensive to identify who will bear the costs of a project, which will reap its benefits; and what the income stages of these dissimilar groups are. It has so been argued that the introduction of distributional issues into project appraisal will so augment the complexity of undertaking a cost benefit analysis that serious inaccuracies could become more common. This argument is very persuasive and may be conclusive for large projects with a diverse group of beneficiaries and whose income stages may be hard to determine. The counter argument put through those supporting social analysis of projects is that, as distributional issues will be implicitly introduced into project analysis in any case, it is much better that they are treated in a constant and rigorous way.

The second problem with the use of distributional weights relates to how the government or project analyst can objectively determine the appropriate set of weights to employ. Even if the distributional impacts of a large project can be traced, the marginal utility of income of these dissimilar groups may be very hard to determine.

Economists such as Harberger and Amin have opposed the formal inclusion of distributional objectives into cost benefit analysis. They claim that, through necessitating comparisons of the welfare that individuals receive from rising their income through a fixed amount, say $ 1, social cost benefit analysis compromises the objectivity of project appraisal. Instead, Jenkins and Harberger recommend merely which groups benefit and which lose from a project, leaving it to decision-makers to determine implicit, rather than explicit, distributional weights.

Supporters of social benefit analysis argue that failure to explicitly compare the utility received through dissimilar income groups within the framework of the project appraisal implies that the analyst gives equal weight to gains in consumption through all income groups, from the poorest and mainly destitute to the wealthiest groups in society. This would only be justified if it were assumed that the marginal utility of income, the change in utility experienced from a given augment in consumption, of all individuals was equal irrespective of their income stages.

Another argument advanced through those opposed to the introduction of distributional issues into cost benefit analysis is that project should be selected in order to maximize national income and that the taxation and welfare systems should then be used to redistribute this income. This is very reasonable and correct view in the case of the developed, higher income countries, which have well developed fiscal and social welfare systems. In several developing countries, though, the fiscal system is weak and even regressive. Large proportions of the population, rich and poor, pay no tax at all and there are few social welfare payments. Corruption and the power of economic elites often ensure that the wealthy evade taxation and wield enough political resistance to creation direct transfers to target groups through the fiscal system. The only acceptable method of creation transfers may be via public sector projects to give social infrastructure, such as schools and hospitals or economic infrastructure, such as roads and irrigation facilities. If economy-wide mechanisms for promoting income redistribution are not accessible there may well be a justification for employing social appraisal of such projects.

In relation to distributional weights, Harberger points out that even if quite moderate distributional weights are employed, it would be possible to sanction acceptance of scandalously inefficient projects. For instance, in Australia it may appear reasonable that changes in consumption enjoyed through families on an income of less than $A 15000 should be given an income distributional weight of 2, and consumption changes through those on an income of more than $A90000 should be given a distributional weight of 0.5. Though, this would imply that a project would be acceptable if it extracted $ 1 from the wealthy, which would then have a social value of $0.50 and gave only $0.25 to the poor, as the latter would then have a social value of $0.50 also. The use of such distributional weights could so result in projects being accepted that entail efficiency losses of 75 percent of costs. Harberger argues that such inefficiency would be quite unacceptable to the electorate and he recommends that, if distributional weights are used, a caveat should be added limiting the extent of acceptable efficiency losses.

FINANCIAL APPRAISAL

WHEN TO UNDERTAKE A FINANCIAL ANALYSIS?

A financial analysis necessity be undertaken if it is necessary to determine the financial profitability of a project to the project implementer. Normally it will only be worthwhile carrying out a financial analysis if the output of the project can be sold in the market, or otherwise valued in market prices. This will approximately always be the case for a privately sponsored project, but will also apply to some government business undertakings. A private firm will primarily be interested in undertaking a financial analysis of any project it is considering, and only in some special circumstances will it wish to undertake an economic analysis.

Commercially oriented government authorities that are selling output, such as railway, electricity, telecommunications, or freeway authorities, will usually undertake a financial as well as an economic analysis of any new project they are considering. They need to assess the project's potential impact on their budget, as well as its impact on the country's welfare. For instance, the Department of Telecommunication offers provision of telephone services at a reduced rate; it needs to look at the impact of the decision on their budget and overall public good. Another situation where a government will be interested in undertaking a financial analysis of a project is when the project is financially viable without the subsidy or other forms of assistance. In practice, governments and international agencies routinely undertake a financial as well as an economic analysis of any project where a financial analysis will have some meaning- essentially, if the output will be sold. It can then compare the results of the financial and economic evaluation, to determine the project's budgetary impact on the government, as the implementer, as well as its contribution to national welfare.

Even non-commercial government institutions may sometimes wish to choose flanked by alternative facilities on the basis of essentially financial objectives. For instance, in the case of a hospital service, the management of hospital could well be required to select the cheapest method of providing a given standard of accommodation or care. A national defense force will often choose flanked by accessible alternative methods of achieving a physical goal, such as airborne troop management capability, on the basis of the cheapest financial option. This procedure is described cost minimization or cost effectiveness. It differs from a full financial analysis in that only the cost of a project is estimated in market or conceivably in economic prices. The benefits are specified in conditions of some quantitative target, such as the number of patient beds to be provided or number of troops that can be moved.

HOW TO VALUE PROJECT BENEFITS AND COSTS IN A FINANCIAL ANALYSIS?

The financial benefits of a project are just the revenues received and the financial costs are expenditures that are actually incurred through the implementing agency as a result of the project. If a project is producing some good or service for sale, the revenue that the project implementers expect to receive each year from these sales will be the benefits of the project. The costs incurred are the expenditures made to establish and operate the project. These contain capital costs, the cost of purchasing land, equipment, factory structure, vehicles and office machines, and working capital, as well as its ongoing operating costs, for labour, raw materials, fuel and utilities. In a financial analysis, all these receipts and expenditures are valued as they appear in the financial balance sheet of the project, and are so measured in market prices. Market prices are just the prices in the local economy, and contain all applicable taxes, tariffs, trade mark-ups and commissions. Since the project's implementers will have to pay market prices for inputs they use and will receive market prices of the output they produce, the financial costs and benefits of the project are measured in these market prices.

Real or Nominal Prices

It is obviously very significant to know whether the input and output projections given through the proposing firm or agency are valued in current prices (normal) or constant prices (real). This is necessary to ensure that the analysis is accepted out in a constant set of prices, so that the total net value of the project ultimately calculated is a real figure.

Often, constant (say 1990) prices, rather than current prices, are used in a project's cash flow. A project's cash flow is merely the costs and benefits paid and produced through the project over its lifetime in the years that they occur. The use of constant prices simplifies the analysis, as it relieves the analyst of the need to create projections about the anticipated inflation rate in the country over the life of the project. This procedure is quite appropriate if input and output prices in domestic currency are expected to augment at almost the same rate over the life of the project.

Though, there are many situations where the use of constant prices may not be appropriate. The first is when the analyst is drawing up project financing plans. In this situation, the analyst will need to estimate expenditures in nominal conditions to ensure that planned sources of finance will be enough to cover all project costs. The second is a situation where the investment is privately operated and will pay company tax. The financial analysis will need to be accepted out in both nominal and real conditions because the rate of inflation will affect the interest payments, depreciation allowance and the cost of holding stocks. All these will influence the firm's tax liability. Working capital necessities will also be affected through the stage of inflation. Finally, if input prices are expected to rise at dissimilar rates over the life of the project, and vary from year to year, it will usually be simpler to contain all prices in current conditions.

Internal Transport and Handling Costs

It is significant to be clear about where inputs and outputs should be priced in a project appraisal. In the case of a project's output, it could be valued at the project gate or in the market for the project's output. In a case of project inputs, they could be valued at the project gate, at the gate of the input supplier's factory or mine or at the port of entry into the country. In order to determine which the appropriate price is, it is necessary to keep in mind that in a financial appraisal it is the net incremental benefit of the project to the implementing agent that is of interest.

In the case of project outputs, they should so be valued at the market price received for them at the project gate. Transport costs from the project to market should be subtracted from the wholesale price received in the market. Project inputs should also be valued at their market cost at the project gate. This price will contain the transport and handling cost of getting them there...

Local and Foreign Costs

Several a times project appraisals split costs (and sometimes benefits) flanked by locally incurred and foreign exchange costs and benefits. This is useful if policy makers wish to judge the impact of the project on the balance payments, or if foreign financing mediators such as aid agencies or multilateral banks wish to see the sharing of items eligible for aid grants or loans.

Usually, even if local and foreign costs are recognized, in a financial analysis all costs and benefits are then expressed in local currency, converted at the official exchange rate. Though, the foreign currency costs may in some instances be expressed in a common international currency like US Dollar, or in conditions of the local currency of a bilateral aid donor country.

In order to separate the cash flow into local and foreign prices, and also to predict the future price of a project's tradable inputs and outputs, it may be necessary to create projections about future exchange rates. To do this it will be necessary to assess, inter alia, if local inflation rates are likely to diverge from average international inflation rates, and particularly those of the host country's major trading patterns. If local inflation is expected to be higher than the average for major trading partners, devaluation of the local currency could be anticipated, rising both the costs of imported inputs and the local currency value of exported outputs. If local inflation is expected to be lower than that of the country's major trading partners, it is likely that the local currency will appreciate over the life of the project. If this is a real appreciation, it will have the effect of lowering imported input prices as well as lowering the local currency receipts from exported outputs and/or reducing the international competitiveness of these exports.

THE CASH FLOW IN THE FINANCIAL ANALYSIS

The Financial Cash Flow

The financial cash flow of a project is the stream of financial costs and benefits, or expenditures and receipts, which will be generated through the project over its economic life, and will not be produced in its absence. Before the cash flow of a project can be estimated, it will be necessary for the project sponsors to undertake detailed market research into product markets and prices. They necessity find out if there will be market for the project's output and what it can be sold for. Then the analyst will need to assess the sources, quantities and costs of required capital assets, raw materials and labour, to estimate the likely costs of the project. It may also be necessary to determine anticipated inflation rates and exchange rate movements, as they may affect the valuation of the project's expenditures and receipts.

Project Life

Early in the procedure of constructing a project's financial cash flow it will be necessary to determine the length of the project's economic life. This will be the optimal period over which the project should be run to maximize its return to the project implementer. The project's life is regularly set equal to the technical life of the equipment used. Though, several factors, such as the technological obsolescence of equipment, changing tastes, international competitiveness or the extent of a natural resource or mineral deposit, may result in the economic life of the project being shorter than the technical life of the equipment employed. If the project is expected to have long term environment impacts, it may be necessary to extend the length of the cash flow so that these costs (or benefits) can be measured.

Capital Costs

The capital costs of a project can be divided into fixed capital costs, or the cost of acquiring fixed assets like plant and equipment, start-up costs, and working capital, which finances the operating expenses of the enterprise. In a financial analysis, all forms of capital expenditure should be entered in the financial cash flow in the years in which the project actually has to pay for them. For instance, if the project receives a soft loan from the supplier of its equipment, which involves a grace period before repaying the loan, the cost of this equipment will not be incorporated in the cash flow until it necessity be paid for through the project.

Operating Costs

The project's operating costs cover its recurrent outlays on labour services (wages and salaries), raw materials, energy, utilities (water, waste removal, etc,), marketing, transport, insurance, taxes and debt service over the life of the project. Each operating cost is entered in the cash flow in the year (month or quarter) in which it is incurred. Total operating costs may also be expressed in conditions of costs per unit of output. As was mentioned previously, unit operating costs are likely to be somewhat higher in the first year or two of a project, so the variation flanked by start-up costs under capital costs, and steady state operating costs will be incorporated as operating costs.

In addition to a financial analysis undertaken from the owner's point of view, the company tax paid on project profits can be calculated in order to determine the project's net present value after tax. A government may do this to determine whether a project seeking subsidies or concessions will be financially profitable after tax or not. A private firm may merely wish to know if a proposed investment will be profitable after tax, given the tax regime of the country concerned. The taxable income of the project will be determined through subtracting all operating costs, interest payments and allowable depreciation on the capital assets from the firm's revenue earnings each year. The appropriate company income tax rate is then applied to this taxable income to determine the project's taxation liability.

If the country gives incentives to new investments in the form of tax holidays or accelerated depreciation of assets, these should be taken into account in the project's taxable income and tax liability. The tax liability is subtracted from taxable income to obtain the project's net of tax income.

Project Benefits

In a financial analysis, the project's benefits equal the cash receipts actually received through the project from the sate of goods or services it produces, or the market value equivalent of home consumed output in the case of non-marketed output. This can be the revenue from sales, rent or royalties, depending on the nature of the project. Other revenue earned from, for instance, bank deposits, the sale of fixed assets or insurance claims, will also be incorporated as separate items under project receipts or benefits.

Net Benefits

The project's net benefit stream is calculated as the variation flanked by the total revenue (or benefit) stream and its expenditure (costs) stream.

DISCOUNTING IN PROJECT ANALYSIS

In project analysis, any costs and benefits of a project that are received in future periods are discounted, or deflated through some factor, r, to reflect their lower value to the individual (or society) than currently accessible income. The factor used to discount future costs and benefits is described the discount rate and is usually expressed as a percentage. For instance, suppose the project is expected to yield a stream of benefits equal to BO, Bl, B2,.... Bn and to incur a stream of costs equal to CO, Cl, C2, Cn in years 0, 1, 2,... n. Then in each period the net benefits (benefits minus costs) of the project will be:

- (B0-C0), (Bl-Cl), (B2-C2),... (Bn-Cn)

This is basically the project's net benefit flow. Assuming that the discount rate, r, is constant, then the discounted cash flow of the project can be represented as:

$$(B_0 - C_0), \frac{(B_1 - C_1)}{(1+r)}, \frac{(B_2 - C_2)}{(1+r)^2}, \frac{(B_3 - C_3)}{(1+r)^3} \cdots\cdots\cdots \frac{(B_n - C_n)}{(1+r)^n}$$

Once future net income streams have been discounted in this way, expenditures and revenues from all the dissimilar time periods will be valued in units of similar value - present day units of currency. They will then be directly comparable with each other and can be added together. Adding the discounted net benefits from each year of the project's life, its discounted net benefit flow, gives a single monetary value described the project's net present value, NPV. For, the previous instance, the project's NPV is:

Table Manual Discounting of a Railway Project Cash Flow ($L Million)

	1	2	3	4	5
Year (t)	Costs	BBenefits	Net Benefits	Discount Factor ll/(l+0.08)t	NNet bBenefits
0	100	00	-100	1	-100
1	400	50	-350	.925	-24.1
2	200	150	[illegible]	.857	-42.9
3	100	200	100	.793	-79.4
4	100	200	100	.735	73.5
5	100	200	100	.681	68.1
6	100	200	100	.63	63.0
7	100	200	100	.583	58.3
8	100	350	250	.54	135.1
Total	**1100**	1550	4450		NPV=10.4

The net present value criterion of a project is the single mainly significant measure of the project's worth. If a project's NPV is positive (i.e. its discounted benefits exceed its discounted costs), then the project should be accepted. If its NPV is negative (its discounted costs exceed its discounted benefits), then the project should be rejected.

In the above table, an 8% discount rate is used to mechanically discount the net benefits of a railway project. The project's NPV can then be estimated through just adding up these discounted net benefits. Columns (1), (2) and (3) show the no discounted costs, benefits and net benefits (benefits-costs) of the railway project. Column (4) gives the discount factor, l/(l+.08)t, through which the non-discounted net benefits in column (3) are multiplied, to obtain the discounted value of these net benefits in each year, t, shown in column (5). These discounted net benefits can then be added together to obtain the total discounted net benefits, or net present value, of the project.

The bottom line of the table shows that the NPV comes to $L10.4 million if an 8% discount rate is used. A NPV greater than zero designates that the discounted benefits of the project are expected to be greater than its discounted costs and the project will so be worth undertaking.

This instance illustrates how crucially the estimation of a project's NPV depends on the discount rate employed. A lower discount rate would have deflated future income through less and increased NPV of the project. A higher discount rate would have deflated future income more heavily and decreased the NPV of the project, perhaps changing it from positive to negative. The selection of the appropriate discount rate is so a very significant issue in project appraisal.

The Discount Rate in Financial Analysis

In a financial analysis market prices are used to value project inputs and outputs, even if these prices are distorted. Market prices are used so that the financial profitability of the project to its implementer can be determined. The market price of capital to the project implementer is the market interest rate, and this represents the cost to the implementer of investing capital in the project. The correct approach to determining the financial discount rate, the discount rate used in the financial analysis, is so to estimate the actual cost of capital to the project implementer This will vary depending on whether at the margin the implementer is a borrower or lender of ingestible funds.

If the project implementer is a net borrower, the interest rate at which the enterprise can borrow is the opportunity cost of funds employed. This market borrowing rate should be used as the financial discount rate for any project appraisal undertaken through the enterprise. If the project implementer intends to draw some funds from its own financial possessions and some from market borrowings, the weighted cost of the capital it obtains from these dissimilar sources will be the appropriate financial discount rate.

If the firm or the government considering a project is a net lender, in the absence of the project it could invest these funds in the financial market and earn the market lending rate. The opportunity cost of the funds to be used for the project will so be the after tax market lending rate that it could earn on this capital. The project necessity earn at least this market lending rate for it to be worth doing and the after- tax lending rate should so be used as the financial discount rate for any project appraisals undertaken through this enterprise. In reality the enterprise will usually want to earn some margin above the market lending rate if the project is measured a riskier use of the firm's funds than accessible financial investments.

Discounted Project Assessment Criteria

The two mainly commonly used discounted measures of a project's net benefit are its net present value and internal rate of return. The domestic resource cost ratio, benefit cost ratio and net benefit investment ratio are also be discussed below:

Project Net Present Value (NPV)

The NPV measure of project worth is the mainly useful and one of the mainly commonly used criteria for determining whether a project should be accepted. The net present value of a project is basically the present value, PV, of its net benefit stream. It is obtained through discounting the stream of net benefits produced through the project over its lifetime, back to its value in the chosen base period, usually the present. The net present value formula is:

$$NPV = \sum_{t=0}^{n} \frac{(B_t - C_t)}{(1+r)^t}$$

Where,

Bt are project benefits in period t
Ct are project costs in period t
r is the appropriate financial or economic discount rate
n is the number of years for which the project will operate

In Table, the NPV of a railway project was estimated mechanically. The net benefits of the project each year were deflated through a factor equal to l/(l+r)t, where r was the discount rate and t the year in which the net benefits of the project were received. These discounted net benefits were then added together for the ‘n’ years of the project. Under this decision rule a project is potentially worthwhile or viable if the NPV is greater than zero; i.e. the discounted value of benefits is greater than the discounted costs. If projects are mutually exclusive, the project which yields the highest NPV would be chosen.

The Internal Rate of Return of a Project (IRR)

The internal rate of return, IRR, of a project is almost certainly the mainly commonly used assessment criterion in project appraisal. This is primarily because the concept of an IRR is in some ways comparable to the profit rate of a project and is so easy for non-economists to understand. Furthermore, it does not rely on the selection of a predetermined discount rate.

The internal rate of return is the discount rate that, if used to discount a project’s costs and benefits, will just create the project’s net present value equal to zero. Therefore the internal rate of return is the discount rate, r*, at which:

$$NPV = \sum_{t=0}^{n} \frac{(B_t - C_t)}{(1 + r^t)^t} = 0$$

Since the internal rate of return is the discount rate internal to the project, its calculation does not depend on prior selection of a discount rate. A project's internal rate of return can so be thought of as the discount rate at which it would be just worthwhile doing the project. For a financial analysis, it would be the maximum interest rate that the project could afford to pay on its funds and still recover all its investment and operating costs.

A project is potentially worthwhile if the IRR is greater than the test discount rate. If projects are mutually exclusive, this rule would suggest that the project with the highest IRR should be chosen.

The Net Benefit Investment Ratio (NBIR)

The net benefit investment ratio, NBIR, is the mainly convenient selection criterion to use when there is a single period budget constraint. NBIR of a project is the ratio of the present value of the project's benefits, net of operating costs, to the present value of its investment cost. Its formula is given through:

$$NBIR = \frac{\sum_{t=0}^{n} \frac{(B_t - C_t)}{(1 + r)^t}}{\sum_{t=0}^{n} \frac{1C^t}{(1 + r)^t}}$$

Where

OCt are the project's operating costs in period t
ICt are the project's investment costs in period t
Bt are the benefits in period t
r is the appropriate discount rate

The NBIR so shows the value of the project's discounted benefits, net of operating costs per unit of investment The decision rule for the net benefit investment ratio is that all projects that have a net benefit investment ratio greater than unity should be selected. This selection criterion is totally compatible with those for the net present value and the internal rate of return of a project.

The Benefit Cost Ratio (BCR)

The benefit cost ratio was the earliest discounted project assessment criterion to be employed. Though, due to troubles associated with its applied use, it is rarely used in project appraisal today. The benefit cost ratio is basically the ratio of the sum of the project's discounted benefits to the sum of its discounted investment and operating costs. This can be expressed mathematically as:

$$BCR = \frac{\sum_{t=0}^{n} \frac{Bt}{(1+r)^t}}{\sum_{t=0}^{n} \frac{Ct}{(1+r)^t}}$$

A project should be accepted if its BCR is greater than or equal to 1, that is, if its discounted benefits exceed its discounted costs.

REVIEW QUESTIONS

- Highlight the role of cost benefit analysis in the project development, evaluation and implementation.
- Discuss the differences flanked by financial analysis and economic analysis?
- Explain the steps in preparing a full economic evaluation.
- Discuss the purpose of social cost benefit analysis.

CHAPTER 6

FINANCIAL CONTROL

STRUCTURE

- Learning objectives
- Executive control
- Legislative control
- System of financial committees
- Review questions

LEARNING OBJECTIVES

After reading this unit, you should be able to:

- Explain the development of Executive Control over expenditure and the growths in the area of financial administration.
- Discuss the organisation of Ministry of Finance.
- Explain the concept of legislative control.
- Explain the concept of Financial committees.

EXECUTIVE CONTROL

DEVELOPMENT OF EXECUTIVE CONTROL OVER EXPENDITURE

Sure fundamental changes have been made in the environment of financial administration in India since Independence. An significant upshot of the changed political and constitutional environment has been the formal acceptance of executive accountability to the legislature as the base of financial administration in India. The vital characteristics of the federal structure introduced in 1935 sustained. Attempts were made to capture the spirit of legislature financial control beside with the institutional ingredients imbued with this democratic spirit.

Before Independence, Government of India Act of 1919 which embodied the recommendations of Montfort Reforms was an significant milestone on the road to decentralization. The central point in financial control was not firmly set in getting the money’s worth of results. The financial rules and procedures as well as the orientation of those who manned the machinery for financial control were heavily accented on regularity and legality. The financial control has sustained to be too slow, too specific and to detailed. Financial and Audit Controls have been more meticulous about enforcing the observance of rules and procedures than to encourage people to prompt and speedy decisions. Major steps towards more delegation of financial powers were made in 1958, 1962, 1968 and 1975. Therefore the high degree of centralization which characterized the system of financial control in British India has been restructured over the 30 years of Independence. The procedures, approaches and the tools of such a control have undergone much change.

The broad functions and structure of finance department at the centre and in the states have remained more or less the same even after Independence. Legislative control over the executive, especially in financial matters, is sought to be achieved through (1) its approval of the detailed expenditure and tax proposals and (2) as well as through its scrutiny of executive’s irresponsibility and irregularities committed in the course of implementation of the budgets. The formal characteristic of accountability to the legislature requires that the executive conducts its affairs in such a way that it is not exposed to adverse criticism. Hence the executive as well as the top layers of the administrative hierarchy are interested in exercising such control over the several stages of administration to prevent irregularities and ensure efficiency and economy in operations.

Like the pre-British Treasury, the Ministry of Finance exercised stringent budgetary control and expenditure control. The Ministry of Finance did not share this responsibility with any other department of the government. The result was delay in the execution of projects and lapse of funds. The

Administrative Reforms Commission in its report on "Finance Accounts and Audit" in January 1968 highlighted this problem and observed that: The Control of the Finance Ministry over public expenditure is exercised, in the main, three stages:

- Approval of programmes or policies in principle,
- Acceptance of provision in the budget estimates, and
- Prior sanction to incurring of expenditure subject to such power as have been delegated to the administrative ministries.

It is the control at the first and the third stages that usually engages much of the time of the Finance Ministry and that impinges on the day-to-day working of the administrative ministries. A control at these stages, if too rigid or detailed involving much time and effort, can slow down the pace of work, delay the implementation of projects—particularly developmental, commercial or industrial and thereby cause loss of national effort or income. While the need for control or scrutiny is not denied, it necessity be constructive, purposeful, imaginative and not narrow in outlook or cramping in effect.

In all responsible governments, control essentially implies the accountability and responsibility of lower to the higher organs in the administrative hierarchy for the money composed and expenditure incurred. In this context the treasury of the Finance Department of the Bureau of the Budget is likely to occupy a strategic position. The Executive control could be exercised when the estimates are prepared or when expenditure is incurred. The units of a department are not usually interested, except in the mainly incidental or indirect way in the general financial troubles of the service or of the government or of the economy as a whole. Their main interest lies in their work. It becomes necessary that the head of several services should scrutinise estimates in conditions of their needs and spending capability. This procedure moves upwards to heads of departments who are expected to moderate the estimates in the light of accepted policies of the government. Under a cabinet system, The Treasury is entrusted with the responsibility to aggregate and consolidate the estimates of the dissimilar departments. In discharging this function the Treasury may be able to influence the departmental estimates through scrutiny and advice.

The Finance Department controls and coordinates several spending departments. The framing of general financial and economic policies and programmes of Government is the responsibility of the Finance Department. The Finance Department prepares the estimates of income and expenditure and submits them to the Parliament for approval. After the Parliament has approved the Budget, the Finance Department plays the mainly significant part in the execution of the Budget. Therefore it is a department of control and supervision whose main duty is to manage the finances of the state.

Grants are voted and appropriations are made through the Parliament to the executive. It is the duty of the executive to spend the money as voted through the Parliament. The maxims of honesty, efficiency, and economy should guide the conduct of the Executive officials while they spend public money. Parliament is the sole authority under the Constitution empowered to sanction funds to the executive for all expenditures. It is the duty of the Parliament to ensure that an adequate machinery exists to see that no money is spent out of the consolidated funds through the executive beyond the appropriations provided through law or the Parliament.

Under the traditional system, the Treasury, down to the heads of the units, assumes responsibility for the efficient and economical expenditure of the funds entrusted to them as soon as the budget is approved through the fund-granting authority. But in the modern times financial administration defines budgetary control as the establishment of departmental budgets relating to the responsibilities of executives, to the necessities of a policy and the continuous comparison of actual with budgeted results. This comparison aims at securing, through individual or communal action, the objectives of the policy or to give a basis for its revision.

Such a control would, though, involve the establishment of a pre-determined standard or target of performance, measurement of the actual performance, comparison with the predetermined standards, the disclosure of deviation flanked by the actual and standard performance and reasons for these deviations, and taking appropriate corrective action where examination of the deviations designates that this is necessary. The execution of the budget means:

- Proper collection of funds
- Proper custody of the composed funds
- Proper disbursement of funds .

ROLE OF THE FINANCE MINISTRY

The Finance Department of the government exercises great control over items of expenditure pertaining to estimates which have been approved through the Parliament, and for which possessions have been duly appropriated. The finance department is always responsible for the whole financial administration of the country. The department performs a diversity of functions with regard to finance of the country. It has control over expenditure of money. It controls and coordinates several spending departments of the government. It is responsible for the collection of taxes. It exercises vital control and supervision over the expenditure of the government departments.

The main duties of the Finance Departments are;

- Administration of the finance of the Central Government and handling of financial matters affecting the country as a whole.
- Raising the necessary revenues for carrying on the administration and regulating the taxation and borrowing policies of the Government.
- Administration of troubles relating to banking and currency and in consultation with the ministries concerned, arranging the proper utilization of the country's
- Foreign exchange possessions.
- Controlling the whole expenditure of the Government in cooperation with the administrative ministries and departments concerned.

Organisation of the Ministry of Finance

The Finance Minister, assisted through a Minister of State in the department of Finance and the Deputy Minister of Finance, manages this mainly significant department of the Government of India. The Ministry is at present divided into the Departments of Economic Affairs, Revenue and Banking and Expenditure. Each department is under the charge of an independent secretary, and for overall coordination of all the departments, there is a Finance Secretary.

Department of Economic Affairs

The Department, of Economic Affairs prepares the central government Budget, creates periodic assessment of foreign exchange needs and possessions and takes steps to mobilize and allocate possessions, internal as well as external, in keeping with developmental and other needs. The department is also responsible for policies relating to insurance, currency and coinage, capital issue and foreign investments, administration of securities contracts (Regulation Act) and regulation of stock exchanges. The Department comprises six main divisions viz:

- Budget
- Planning
- Internal Finance
- External Finance
- Economic and
- Insurance

The Budget division of the Department of Economic Affairs is responsible for the preparation and presentation to Parliament the Budget of the Central Government. This division performs the whole function of coordination, collection and consolidation of data relating to receipts and expenditure of Government. The Internal Finance division is concerned with all matters linked with currency and coinage, Reserve Bank of India, Price control etc. The Planning division is concerned with the work linked with the preparation of the capital Budget and the allocation of ceilings of capital expenditure of the several ministries. External Finance division is responsible for matters relating to foreign exchange, budget foreign investments etc. The Economic division is an advisory wing of the department of Economic Affairs. Its main function is to look at trends in the economy and to carry out studies and research with a view to advising the Ministry on questions of economic growths abroad, particularly those which have a bearing on the Indian economy. Insurance division deals with the administration of the Life Insurance Corporation.

The Department of Revenue and Banking

The Revenue wing of the department, deals with the following subjects: Income tax. Wealth tax, Expenditure tax, Customs, Central Excise, Opium and Narcotics and central functions under the Indian Stamps Act. The Banking wing of the Department of Revenue and Banking is concerned with the formulation and implementation of Government policies having a bearing on the commercial banks and long-term financial institutions excluding LIC and UTI.

The Department of Expenditure

The department of expenditure is divided into the following divisions:

- Establishment Division including Implementation Cell and Staff Inspection Unit
- Defense Finance Division
- Cost Accounts Wing
- Plan Finance Division and
- Special Cell

The Department of Expenditure is mainly concerned with the administration of expenditure control.

Evaluation of the Role of Ministry of Finance

The Control of Finance Department extends to the practice of requiring specific authority through the Finance Department for every item of expenditure even after the general policy has been accepted as a result of sanction through the Parliament. Such an excessive control of the Finance

Department over the finances of the country resulted in concentration of authority in only one Department of the Government. The result of the centralization of such powers is that there is no delegation of financial authority even to the high ranking and responsible officers of the several administrative ministries. The scrutiny of expenditure through Ministry of Finance after Budget has been approved through the Parliament is due to the fact that often Administrative Ministries submit their schemes to the Finance Ministry throughout the last moments of the preparation of the estimates. There is usually inadequate prejudged scrutiny for want of details in the case of several schemes. Since often schemes are incorporated in the Budget without prior scrutiny it becomes necessary for the Ministry of Finance to undertake. the examination after the Budget has been approved and before they are actually executed. So, unless the expenditure sanctions are issued with the concurrence of the Finance Ministry, no part of the expenditure can be incurred. To avoid such a delay, prebudget scrutiny of the schemes through the administrative ministries and the Finance Ministry should be complete and detailed. The Estimates Committee in its ninth Report, concerning Administrative, Financial and other reforms has probed the problem in detail. The committee also observed that there should be coordination flanked by the Finance Ministry and the Administrative Ministries. There should be more delegation of financial authority to the administrative Ministries. The committee observed that concrete steps should be taken to establish perfect cordiality flanked by the administrative Ministries and the Ministry of Finance and to see that one is complementary to the other and helps in the ultimate objectives. The committee made the following recommendations.

- Before a scheme is embarked upon, it should be properly planned and it should also be ascertained, whether the money required for it is accessible or can be made accessible at the proper time. Detailed plans and estimates should be worked out to enable the Ministry of Finance to approve the schemes and accord financial concurrence.
- After the scheme is approved from the financial point of view through the Ministry of Finance, detailed execution of the scheme and spending of money thereon should be the responsibility of the administrative Ministry concerned which should also be given power to vary or alter amounts under the sub-heads of the scheme so long as the total outlay is not affected.

Therefore, on the basis of recommendations of the Estimates Committee, procedures and methods ought to be developed which should remove delay and bring efficiency to financial control. Delegation of financial responsibility to the administrative ministries is necessary. Although the overall control has to be exercised through the Ministry of Finance, administrative ministries should be given more powers to incur expenditure on several schemes and plans. The financial responsibility and consciousness for economy should be promoted in all the administrative departments. Each ministry should prepare its Budget in as detailed a manner as possible and work out the details of all schemes to be executed through the ministry in the ensuing financial year

DELEGATION OF FINANCIAL POWER

These powers were further enhanced in 1954 and 1955. A.K. Chanda, the then Comptroller and Auditor General of India, who undertook the task of preparing a plan for delegation of financial powers and for a reorganization of the system of financial control, submitted his proposals for the consideration of the Public Accounts Committee of Parliament While pinpointing the defects in the existing system, he recommended that, to avoid delays in the issue of expenditure sanctions, the particulars of the proposals referred through the administrative ministry to the Ministry of Finance at the prebudget review stage should be furnished in greater detail to enable the Finance Ministry to carry out a better and more systematic prebudget scrutiny. A breakthrough, of key importance, came in 1958, when the Government of India sought to delegate financial powers to the administrative Ministries.

Though, the Ministry of Finance continues to be responsible for creation a reasonable and fair sharing of the total sum determined through its ways and means position amongst the several programmes and activities of the government within the framework of the plan. The Government has recognized the need for rationalizing the procedures for expenditure sanctions and delegation of powers to the administrative ministries in their several delegation schemes. The main objectives of these delegation schemes has been to improve the procedure for prebudget scrutiny and to delegate within broad limits powers of post-budget expenditure sanctions to the administrative departments

The delegation schemes have exhorted the administrative ministries to red legate, in their turn, administrative and financial powers to heads of departments and to other subordinate authorities with due regard to their respective stages of responsibility. It is well recognized that for a system of delegation to be effective, the powers delegated should step down the line and be commensurate with the responsibilities to be discharged at the several official stages. The need for delegation would vary in the case of dissimilar organisations depending on their respective programme necessities and on whether they are to exercise such powers in normal times or in times of crisis. For a meaningful operation of a scheme of delegation the exercise of powers through the delegate should be insisted upon. The Ministry of Finance should send back a case without expressing its views if the matter falls within the delegated powers of an administrative ministry. In the same way, the administrative ministries and heads of departments should insist upon the decisions being taken at stages vested with adequate powers. The need for speedy and efficient dispatch of the public business creates it imperative that the functionaries at dissimilar stages should create full use of the powers delegated to them.

The Estimates Committee in its Ninety-eighth report in 1975-76 observed that there is a need for further red legation of powers to the field agencies which have the primary responsibility for execution of schemes and attaining set targets. The Committee endorsed the view that it is essential that they should have adequate powers commensurate with the responsibilities to be discharged through them. The Committee suggested that one of the ways to ensure that delegated powers are actually exercised is to make proper atmosphere to it. The officers should be consciously encouraged to develop initiative and take decisions. It should also be ensured that methodical and conscious work and exercise of powers entrusted to officers is recognized and appreciated while bonfire commissions and commissions are not held against them.

The A.R.C. revise team on Financial Administration observed that—"A scheme of delegation of financial powers which does not become operative until the last detail is approved through the Finance Ministry is unsatisfactory. Once the preliminary feasibility report has been prepared and accepted through the government, the administrative ministry should be permitted to sanction expenditure on essential preliminary items, subject to a sure limit, in a fixed preparation or percentage of the estimated costs." "If the project is to be implemented without delay, the need for delegating some powers to the administrative ministries for incurring expenditure on the essential preliminary items becomes significant. It is, so, suggested that after the preliminary feasibility report has been examined and approved through the government, the administrative ministries should have powers to incur expenditure within sure limits on the essential preparatory items pertaining the project."

Under the latest delegation schemes the administrative ministries have been given full powers of expropriation within a grant, provided there is no diversion of funds from plan schemes to non-plan activities and there is no augmentation of the total provision made for administrative expenses under a scrupulous grant. In actual practice, the administrative ministries enjoy enough freedom in the matter of re appropriation of funds, even in these cases where expropriation of funds could, under the rules, be done only with the prior sanction of the Ministry of Finance.

LEGISLATIVE CONTROL

CONCEPT OF LEGISLATIVE CONTROL (h1)

Parliament exercises control over revenue, expenditure, borrowing and accounts. Legislative sanction is required for the levy of new taxes or for the augment in the, rates of existing taxes, for the withdrawal of money from the Consolidated Fund for public expenditure, and for raising of loans. Public Accounts are scrutinized through the Public Accounts Committee and are audited through a statutory authority which is independent of the executive. In Indian context, the following four principles of financial control are being followed:

- The executive, acting through Ministers cannot raise money through taxation, borrowing or otherwise without the authority of Parliament; proposals for expenditure requiring additional funds necessity emanate from the cabinet.
- The second principle is the Control that vests in the Lok Sabha which has the exclusive control of the Money bills. These necessity originate in the Lok Sabha which has the sole power to grant money through way of taxes or loans and to authorize expenditure. The Rajya Sabha may reject a grant but not add to it.
- The demand for grants necessity come from the Government. Neither the Lok
- Sabha nor a State Assembly may vote a grant except on a demand for grant from the Government.
- Likewise, the proposal for a new tax or for an augment in the rate of an existing tax necessity come from the Government.

In India the instruments of legislative control are: Questions, Adjournment motions, Resolutions, Votes, Budgets, and Legislative Committees—Public Accounts Committee, Estimates Committee, Committee on subordinate legislation and the Committee on Assurances. These tools of exercising legislative control are described here briefly.

Question Hour

The first hour of every Parliamentary day is reserved for questions, which give an effective form of control. Questions asked can keep the whole administration on its toes. A question is an effective device of focusing public attention, in a striking manner, on dissimilar characteristics of administration's policies and activities. Any administrative action can provoke a question, though the member cannot compel the Minister to provide the answer. The Speaker, too, may disallow sure questions. A question is asked with a view to getting information, obtaining ministerial opinion on a subject or basically hammering the government on alleged weak points. Several of the questions, may be trivial, but some do cause tremendous harm to the Government—the Life Insurance Corporation episode of 1956 resulting in the resignation of Finance Minister arose from an answer to a question.

This is a widely recognized, popular and commonly employed method of ensuring accountability. From time to time members have been raising matters of great importance through their questions.

Adjournment Debates

The device of adjournment motion is a tool of day-to- day control, and may be utilized for raising a discussion in the House on any specific question of urgent nature and of public importance. If allowed through the presiding officer, an immediate debate takes place on the matter raised, therefore suspending the normal business of the House. In practice, it has been seen that the Speaker has shown a constant tendency not to interpret the term ‘urgent nature and of Public importance’ liberally.

Debates on Enactment of Acts and Amendments

The several readings of a bill give opportunities to the members of Parliament to criticize the whole policy underlying the bill. The criticism may even create the Government change its mind. The Government, for instance, withdrew the highly controversial Hindu Code Bill in 1951. Likewise, whenever Parliament is approached for the amendment in the Act, the members again get an opportunity to discuss the same.

Budget Discussion

Since the introduction of the Budget on Account Parliament has greater opportunity of discussion on the budget proposals. The members of Parliament have several opportunities of discussing the budget, on the following occasions:

- After the presentation of the budget, general discussion takes place. On this occasion the discussion relates to the budget as a whole or any question of principles involved therein.
- Voting on grants gives the second opportunity. Discussion at this stage is confined to each head of the Demand, and, if cut motions are moved to the specific points raised therein, the discussion is sufficiently pointed and may be focused on specific points.
- Discussion on the Finance Bill gives an endless opportunity to discuss the whole administration. In the words of G. V. Malinger, “It is an acknowledged principle that any subject can be discussed on the Finance Bill and any grievance ventilated. The principle being that the citizen should not be described upon to pay, unless he is given, through Parliament the fullest latitude of representing his views and conveying his grievances.”

President's Speech

The President addresses both the Houses of Parliament assembled together at the commencement of the Budget session. The address is prepared through the Government and each Ministry is responsible for the portion pertaining to it. The President's Speech broadly spells out the major policies and activities with which the executive would be pre-occupied in the period immediately ahead. The members of Parliament have an opportunity to criticize the whole realm of administration for its alleged acts of commission and commission.

Parliamentary Committees

Parliamentary Committees—Public Accounts Committees, Estimates Committee, Committee on Public Undertakings, Committee on subordinate legislation and Committee on assurances—are also tools of control over administration. The first three committees exercise detailed and substantial control, and the Committee on assurances undertake a scrutiny, of promises, assurances, undertakings, etc., given through the Ministers from time to time, on the floor of the House and it reports on:

- the extent to which such assurances, promises etc., have been implemented and
- where implemented, whether such implementation has taken place within the minimum time necessary for the purpose. The subsistence of such a committee creates Ministers more careful in creation promises.

Audit

Parliament exercise control over Public expenditure through the Comptroller and Auditor General who audits all Government accounts to ensure that the money granted through Parliament has not been exceeded without a supplementary vote and money expended conforms to rules. The accountability of Government to Parliament in the field on financial administration is therefore, secured through the reports of the Comptroller and Auditor General who has rightly been described as the guide, philosopher and friend of the Parliament.

HISTORICAL BACKGROUND OF LEGISLATIVE CONTROL

Though full legislative control over the budget is a concept of this country, historically the concept of budget began to develop in the late middle ages when the revenue was to be composed from the king's domain. Hence the budget was a statement of revenue and expenditure. Throughout the wars and other emergencies when the King required a lot of money for running the affairs of the state, he had to consult the nobility to know their views on the taxes. The expenditure still remained a prerogative of the king. Only after the 1688 revolution, the Principle of No revenue without representation' got recognized. The control over expenditure had still not acquired the conventions of legislative approval.

•The system of legislative control over Public finance first arose in England and it was more a growth than a creation. The first step that was taken in this direction throughout the reign of King John was towards the control of receipts and revenues rather that of expenditure. The Stuart autocracy made the Parliamentarians more exacting and they began to claim a share in the control of Public expenditure as well. But this did not come about suddenly or according to any concerted plan or design it was a very gradual development.

The establishment of the accounting and reporting system in 1787, the audit system under the Exchequer and Audit Department Act of 1866, and the constitution of a Standing Committee of Public Accounts in the House of Commons in 1866 were important historical growths in the arena of Legislative Control.

Therefore was built up the modern system of Audit and Report through which the Legislature controls the finances of the state. The system of legislative control in India is more or less based on the system prevailing, in England.

PROVISIONS IN THE CONSTITUTION, 1950

The Constitution of India gives in its several articles the legislative procedure and procedure in financial matters. The main provisions of Indian Constitution are given below:

- As per Article 107 (i) subject to the provisions of Articles 109 and 117 with respect to Money Bills and other financial bills, a bill may originate in either House of Parliament and subject to the provisions of Articles 108 and 109 a Bill shall not be deemed to have been passed through the House of Parliament unless it has been agreed to through both Houses, either without amendment or with such amendments only as are agreed to through both Houses.
- Article 109 (1) gives that a Money Bill shall not be introduced in the Council of States. As per Article 109 (2), after a Money Bill has been passed through the House of the People it shall be transmitted to the Council of States for its recommendations and the Council of States shall within a period of fourteen days from the date of its receipt of the Bill return the Bill to the House of the People with its recommendations and the House of the people may there upon either accept or reject all or any of the recommendation of the Council of States. As per Article 109 (3), if the House of the People accepts any of the recommendations of the Council of States, the Money Bill shall be

deemed to have been passed through both the Houses with the amendments recommended through the Council of State and accepted through the House of the People.

- Article 112(1) gives that the President shall in respect of every financial year cause to be laid before both the Houses of the Parliament statement of the estimated receipts and expenditure of the Government of India for the year. Such a statement is described "Annual Financial Statement".
- As per Article 113 (1), so much of the estimate as related to the expenditure charged upon the Consolidated Fund of India shall not be submitted to the vote of the Parliament. But nothing in this clause shall be construed as preventing the discussion in either House of Parliament of any of those estimates.
- Article 114(1) gives that as soon as the grants under Article 113 have been made through the House of the People, there shall be introduced a Bill to give for the appropriation out of the Consolidated Fund of India of all moneys required to meet:
    - the grants so made through the House of the People, and
    - the expenditure charged on the Consolidated Fund of India but not exceeding in any case the amount shown in the statement previously laid before Parliament.

As per Article 116(1), the House of the People shall have power:

- to create any grant in advance in respect of the estimated expenditure for a part of any financial year pending the completion of the procedure prescribed in Article 113 for the voting of such grant and the passing of the law in accordance with the provisions of Article 114 in relation to that expenditure.
- to create a grant for meeting an unexpected demand upon the possessions of India when on account of the magnitude or the indefinite character of the Service, the demand cannot be stated with the detail ordinarily given in an annual financial statement;
- to create an exceptional grant which forms no part of the current service of any financial year, and the Parliament shall have power to authorize through law the withdrawal of moneys from the Consolidated Fund of India for purposes for which the said grants are made.

As per Article 117 (1) A Bill or amendment creation provision for any of the matters specified under Article 110 shall not be introduced or moved except on the recommendation, of the President and a Bill creation such provision shall not be introduced in the Council of States. No such recommendation shall be required for moving an amendment creation provision for reduction or abolition of any tax. Article 117 (b) also gives that a

Bill which, if enacted and brought into operation, would involve expenditure from the Consolidated Fund of India shall not be passed through either House of Parliament unless the President has recommended to that House the consideration of the Bill.

CONTROL OVER TAXATION

Legislation of the Budget is through no means complete until a provision has been made for collecting the required money from the people. For this purpose a Finance Bill is placed before the House. This bill embodies the taxation or revenue proposals for the financial year that is, it comprises all the existing taxation schemes with modification or without modification.

This practice is quite in consonance with the well recognized principle of democracy that “no tax shall be levied or composed except through authority of law”, as embodied in Article 265 of our Constitution. So while the passage of the Appropriation Bill authorizes the Government to appropriate money from the Consolidated Fund, the passage of the Finance Bill authorizes it to collect taxes.

The Finance Bill is the bill embodying the Government's Financial (Taxation) proposals for the ensuing financial year which has to be passed through the Parliament every year. It is open to general and clause through clause discussion. Amendments may propose the abolition or the reduction of any tax but may not propose new tax or an augment in the rate of any existing tax. The Bill as amended is passed through the Lok Sabha and after consideration through the Rajya Sabha it goes to the President for his signature after which it becomes an Act.

Money Bill is one dealing with taxation, borrowing, or expenditure. Budget proposals are placed before both the Houses of Parliament at the opening of the budget session. The authority for money bills is with Lok Sabha and it is, so, the Lok Sabha that proceeds with Bill. The Finance Minister presents his annual financial statement to the Lok Sabha and the presentation is followed through a general discussion of the financial statement as a whole in both the Houses separately. No item of expenditure is exempted from general discussion. But the discussion is to be only of a general character relating to policy and involving a review and the criticism of the administration of the Department concerned and members may provide vent to the grievances of the people.

A Money Bill, though, differs from the Finance Bill in the following respects:

- A Money Bill deals exclusively with taxation, borrowing or expenditure. Whereas Finance Bill has a broader coverage in that it deals with other matters as well.
- A Money Bill is a Bill certified to be such through the Speaker of the Lok Sabha

- A Money Bill necessity be returned through the Rajya Sabha to the Lok Sabha within 14 days of its receipt with its recommendations, if any, which the Lok Sabha is not bound to accept. Disagreement over a Finance Bill though, is resolved at a joint sitting through a majority of the total number of members present and voting.

CONTROL OVER PUBLIC EXPENDITURE—AN EVALUATION

The function of the legislature does not end with the voting of grants for public expenditure. Is has also to see that the funds granted are spent faithfully and economically according to its direction. The Parliament has to satisfy itself that the

funds have been applied to purposes approved (2) within the amounts appropriated and (3) that waste and extravagance have been avoided. For this purpose, there is an independent audit of all the departmental accounts through the Comptroller and Auditor General of India followed through an examination of his report through a Parliamentary sub Committee.

Joint responsibility of the political executive to the Parliament is an essential characteristic of Parliamentary democracy. The mainly significant control exercised through the Parliament over the executive is its control on the purse strings. The executive can not spend any money without authorization from the Parliament.

Audit through Comptroller and Auditor General of India

The control of Parliament over expenditure is complete only when it can assure itself that the funds were spent through the executive for the purposes for which they were granted. This is ensured through the provision of audit of the accounts through an independent authority, viz. the Comptroller and Auditor General of India. He audits all expenditures of the union and the States and ascertains whether moneys shown in the accounts as having been disbursed were legally accessible for and applicable to the purposes for which they have been used. He audits all other accounts of the Centre and the States. He submits his audit report to the President and the Governors to be placed before Parliament and the State Legislature. He reports on any waste and inefficiency. He comments clearly on matters of accounting or financial principle which are in dispute, transactions where heavy losses have occurred or might occur, expenditure on new services and departure from settled precedents and procedures. To ensure a thorough audit and full report to the Parliament the Comptroller and Auditor General of India has been given an independent status through the Constitution.

Since the Parliament is too unwieldy a body for a serious technical discussion on the C.A.G.'s reports, it sends the reports for detailed examination to sure committees of the Parliament. Some significant committees of this kind are discussed below:

The Public Accounts Committee (P.A.C.)

The audit report of the Comptroller and Auditor General is presented to the Parliament. The examination of the audit report is entrusted to a special committee of the Parliament recognized as the Public Accounts Committee.

Rule 143 relating to Control of Committee on Public Accounts gives:

- In scrutinizing the appropriation accounts of the Government of India and the report of the Comptroller and Auditor General thereon, it shall be the duty of the Committee on Public Accounts to satisfy itself:
    - that the money shown in the accounts as having been disbursed were legally accessible and applicable to the service or purpose to which they have been applied or charged
    - that the expenditure conforms to the authority which governs it, and
    - that every re-appropriation has been made in accordance with the provisions made in this behalf in the Appropriation Act, or under rules framed through
    - to look at such trading, manufacturing and profit and loss accounts and balance sheets as the President may have required to be prepared and the C.A.G.'s reports thereon.
    - to consider the report of C.A.G. in cases where the President may have required him to conduct audit of any receipt or to look at the accounts of stores and stock.

The conclusions of the Public Accounts Committee on the audit report of the C.A.G. are submitted to the Parliament with recommendations for action through Government wherever necessary. Therefore the Public Accounts Committee is the mechanism to secure the accountability of the executive in respect of expenditure voted through the Parliament.

The Estimates Committee

Through the mechanism of the Public Accounts Committee, the Parliament has been able to secure the accountability of the executive in respect of expenditure voted through it. It is through the mechanism of the Estimates Committee that the Parliament subjects the estimates of the Finance Ministry to a detailed scrutiny before they are submitted to the Parliament.

The functions of the Committee are to:

- Report what economies, improvements in organizational efficiency or administrative reform, constant with the policy underlying the estimates may be effected,
- Suggest alternative policies in order to bring about efficiency and economy in administration,

- Look at whether the money is well-laid out within the limits of the policy implied in the estimates,
- Suggest the forms in which the estimates shall be presented to the parliament.

The Committee selects some departments each year, examines their working in great detail and creates the suggestions on organisations, economy etc. including policy matters.

Committee on Public Undertakings

The examination of Public Undertakings through the COPU is in the nature of the evaluation of the performance of Public Undertakings covering significant characteristics such as implementation of policies, programmes, management, financial success etc. The Committee considers the part of the C.A.G.'s report on Public Undertakings transferred to it. After examination of the report, COPU sends it to the Parliament beside with its own comments. The reports of this committee beside with C.A.G.'s reports give a very effective instrument of control of Parliament over Public expenditure.

Parliament's Direct Control

The Parliament exercises direct control over Public expenditure through examining the reports of the committee on Public Accounts and Estimates Committee. A general discussion is held on the reports submitted through the Committees and the Auditor General's reports. The Government has to reply to the charges made, if any.

Hence from the foregoing discussion it is clear that the Parliament sanction funds to Government for spending but it takes appropriate steps to see that:

- Expenditure is according to the rules prescribed
- There is economy in expenditure, and
- There is no fraud, embezzlement or misappropriation.

SYSTEM OF FINANCIAL COMMITTEES

NEED FOR COMMITTEES

Effective legislative control over the expenditure of the government requires the Parliament to satisfy itself that the appropriations have been utilized economically for the approved purposes within the framework of the grants. It should also undertake a detailed examination of the annual budget estimates of the government to suggest possible economies in the implementation of plans and programmes embodied therein. Both these functions are of pivotal importance in creation the parliamentary control over governmental expenditure comprehensive. It; so, constituted three committees, composed of members belonging to it, to devote themselves to these functions. These three committees are:

- Public Accounts Committee
- Estimates Committee
- and the Committee on Public Undertakings.

State legislatures also have similar committees though all of them do not have separate committees on public undertakings.

PUBLIC ACCOUNTS COMMITTEE

Historically, the Webly commission of 1896 indicated the need for an accounts committee to highlight financial irregularities. The Montague Chelmsford reforms suggested the creation of such committees out of the provincial legislatures. The first such committee on Public Accounts was created at the centre to deal with the appropriation of Accounts of the Governor General in Council and the report of the Auditor General thereon. The British Parliament acquired power to grant appropriation with the Revolution of 1688. The power to ascertain how the money had been spent was conferred only in 1861, when the House of Commons created the committee on Public Accounts.

In India, the Public Accounts Committee was first created at the centre in 1923 with the coming into force of the Montford reforms in 1921. It became a major force in the legislative control of Public expenditure. Despite the limitations of its constitution and the restrictions on its authority, it exercised enormous influence in bringing to bear upon government the need to enforce economy in the expenditure of public money. Committee of Parliament, described the Public Accounts Committee. A committee of Parliament is preferred because the Parliament does not have the time to undertake detailed examination of the report. Secondly, the scrutiny being technical, can best be done through a committee and, lastly, the non-party character of the examination is possible only in a committee but not in the house.

Composition

Under the provisions of the Constitution, the Public Accounts Committee at the Centre is constituted of members from both the Houses of Parliament; it is composed of 22 members, 15 from the Lok Sabha and 7 from the Rajya Sabha. The members are elected through a system of proportional representation through single transferable vote. Approximately every sizeable party or group is represented on the Committee. Although the committee is elected annually, there is a convention that there should be a two year tenure of the membership to ensure stability. The Chairman of the Committee is nominated through the Speaker from amongst the members of the Committee. Till 1966-67, the chairman belonged to the ruling party. Since then, a member of the opposition has been named the Chairman.

Functions of the Committee

The functions of the Committee are to satisfy itself that

- the moneys shown in the accounts as having been disbursed were legally accessible for and applicable to the service or purpose to which they have been applied or charged; ‘
- the expenditure conforms to the authority which governs it; and
- every expropriation has been made in accordance with provisions made in this behalf under the rules framed through the competent authority.

It shall also be the duty of the Public Accounts Committee:

- to look at, in the light of the report of the Comptroller and Auditor General, the Statement of accounts showing the income and expenditure of state corporations, trading and manufacturing schemes and projects, together with the balance sheets and statements of Profit and Loss accounts which the President may have required to be prepared, or are prepared, under the provisions of the statutory rules regulating the financing of a scrupulous corporation, trading concern, or project;
- to look at the statements of accounts showing the income and expenditure of Autonomous and Semi-autonomous bodies, the audit of which may be mannered through the Comptroller and Auditor General of India either under the direction of President or through a statute of Parliament; and to consider the report of the Comptroller and Auditor General in cases where the President may have required him to conduct an audit.

The committee also reviews the form and details in which the estimates are prepared in order to arrest any tendency to reduce the number of votes or to contain large lump-sum provisions since these are regarded as diminishing the control of Parliament over the estimates. It goes into the technical accounting procedure, in order to find out its adequacy or otherwise to control departmental extravagance.

Working of the Committee

The Public Accounts Committee can organize itself into sub-committees and working groups. When approved through the committee, the reports of the subcommittees are deemed to be the reports of the Public Accounts Committee. The Committee may send for persons, papers and records. The conclusions of the committee are submitted to Parliament in the form of a report. To create the work of the committee more effective, the Comptroller and Auditor General now submits interim reports to it. The committee is therefore able to reach the conclusions and finalize its recommendations. It has at its disposal the services of the Comptroller and Auditor General, who is the guide, philosopher and friend of the committee.

A convention has evolved that the recommendations of the Committee are accepted through the Government. But sometimes these are sent back for reconsideration Mainly of the issues are therefore settled through mutual discussion and free and frank exchange of views. The Public Accounts Committee probes into the transactions accepted out It conducts a post-mortem examination of the Public Accounts. To quote the first Speaker of the Lok Sabha (in the speeches and writings of G.V. Mavalankar. Speaker to PAC, p. 97)—"The very fact of consciousness that there is someone where will scrutinize what has been done, is a great check on the slackness or negligence of the executive." The examination, if it is properly accepted out, therefore, leads to general efficiency of the administration. The examination through the committee may also be useful as a guide for both future estimates and policies. The control exercised through the Public Accounts Committee is quite important. The controls relate to financial matters and are quasi-judicial in nature As a watchdog it acts as a deterrent on excesses committed through the executive It is hoped that the committee will emerge as an effective force in the control of Public expenditure

ESTIMATES COMMITTEE

The Estimates Committee was first created in April, 1950 and its functions were enlarged in 1953. There had been a predecessor or Estimates Committee, described the Standing Finance Committee, which was first constituted in 1921 and attached to the Finance Department of the Government of India. This committee depended on the will of the executive. It had no statutory status. Its functions were not clearly defined and its deliberations were not satisfying to the elected representatives of the legislative assembly.

Composition

The Estimates Committee, constituted in 1950 had 25 members; in 1956 the membership was revised to 30. It is a select committee elected through the members of the Lok Sabha from amongst themselves according to the principle of proportionate representation based on single transferable vote. The term of office of the members is one year. But according to conventions, two-thirds of the members are re-elected for another year. The Chairman of the Committee is nominated through the Speaker. If, though, the Deputy Speaker is a member of the Committee he automatically becomes the Chairman. Ministers cannot be appointed on the Estimates Committee. Its functions, methods of appointments and other relevant matters are laid down in the Rules of Procedure and conducting of Business in the Lok Sabha.

Functions

The committee examines such of the estimates as it may deem fit or are specifically referred to it through the Lok Sabha or the Speaker to:

- Report what economies, improvements in organisation, efficiency and administrative reforms, constant with the policy underlying the estimates, may be affected;
- Suggest alternative policies in order to bring out efficiency and economy in
- Administration;
- Look at whether the money is well laid out within the limits of policy implied
- In the estimates; and
- Suggest the form in which the estimates shall be presented to the Parliament.

While examining the policies of the government the Estimates Committee does not lay down any policy. It can only see whether the policies laid down through Parliament are accepted out. The vital functions of the committee are to ensure efficiency and economy in administration. The Estimates Committee can constitute one or more sub-committees. The reports of the sub-committees are deemed to be the reports of the whole committee.

Working of the Committee

The tenure of members is one year but stability is maintained through re-electing members. Once a decision is taken as to the estimates to be examined, the Committee collects and collates material required for an adequate examination of the expenditure. The papers are put before the committee for preliminary scrutiny and further information, if needed, is composed. It may constitute a sub-committee which issues a questionnaire to the concerned ministries for furnishing full and complete answers to the points raised. The Committee has power to send for papers, persons, and records. Sometimes revise groups are appointed to undertake as on the spot revise of the projects under examination. After completing the examination of the witnesses, the committee formulates its recommendations.

The Committee submits its report to the House. The recommendations of the Estimates Committee relate to:

- Improving the organisation and working of the department;
- Securing economies, and
- Providing guidance in the presentation of the estimates.

The Committee has always interpreted its conditions of reference in a liberal way. It takes the view that economy, efficiency and organisation are interconnected. The Estimates Committee is therefore performing a useful work. Majority of its recommendations are accepted through the Government, as is revealed from the reports on the implementation of recommendations submitted through the Estimates Committee from time to time. Functional and Economic Classification of budget, introduction of performance budgeting, and so on are some of the far reaching recommendations of the Committee. The Estimates Committee is performing a useful function in improving the efficiency of administration in India. The work of the Committee can be improved through having sub-committees. The ultimate success of the Committee, though, rests on the influence it exercises on the Government in its long-term thinking and planning.

COMMITTEE ON PUBLIC UNDERTAKINGS

Till April 1964 the affairs of Public Enterprises in India used to be looked after through the two Committees: namely the Estimates Committee and Public Accounts Committee. But in view of vast investments and manifold augment in the activities of public enterprises it was felt that there should be a separate agency which should look into the working of public enterprises in detail and report to the Parliament. In 1964, on the recommendation of the Krishna Menon Committee, a separate committee on Public Undertakings was constituted. This committee, which started functioning from May 1, 1964 took over the work relating to autonomous Public Enterprises from the other two Committees viz the Estimates Committee and the Public Accounts Committee.

Composition

Earlier there used to be 15 members in the Committee, with 10 members from the Lok Sabha and 5 members from the Rajya Sabha. With effect from April 1974, the number of members has been increased to 22.... 15 members of COPU are drawn from the Lok Sabha and 7 members are drawn from the Rajya Sabha. The members of COPU are elected every year in accordance with the principles of proportional representation through means of single transferable vote.

Functions of COPU

The Principal functions of COPU are:

- To look at the reports and accounts of Public Undertakings as specified in the fourth schedule of the Rules of procedure and conduct of Business in Lok Sabha;
- To look at the reports, if any, of the Comptroller and Auditor General of India on the Public Undertakings;
- To look at, in the context of autonomy and efficiency of the public undertakings, whether the affairs of the Public Undertakings are being supervised in accordance with sound business principles and prudent commercial practice;
- To exercise such other functions vested in the Public Accounts Committee and the Estimates Committee in relation to the Public Undertakings as are not sheltered through clauses (a), (b) and (c) above and as may be allotted to the committee from time to time.

The COPU shall not look at:

- Matters of major Government policy as separate from business or commercial functions of Public enterprises; matters of day-to-day administration, matters for consideration for which machinery is recognized through any special statute under which a scrupulous Public Enterprises is recognized.

Working of the Committee

The COPU has been doing commendable work since its inception in 1964. In the very first year (1964-65) it submitted 11 reports. Throughout the third Lok Sabha it submitted 40 reports. Throughout 5th Lok Sabha it submitted 56 reports. The COPU undertakes horizontal studies also. So far it has prepared nine horizontal reports. They are, township and factory structures; management and administration; Materials Management, Financial Management, Public relation and publicity, Production Management, Personnel Policies and Labour Management relations; Role and attainment of Public Sector Undertakings and Foreign Collaborations. These horizontal reports are very useful as they contain valuable information about one scrupulous characteristics of all enterprises taken together.

The Committee asks the ministry and the enterprises to furnish necessary material relating to chosen subjects. The committee often visits chosen enterprises for informal discussions. After the revise tours, and after getting formal memorandum and other information from concerned parties, non-official and official witnesses are invited to provide proof at formal sittings of the committee held at Parliament House. All proof given before the Committee is treated as confidential. The committee gives a whole lot of real and useful information on Public Enterprises operations. The enterprises are studied in some detail covering significant characteristics of their working with a view to creation an evaluation of their performance.

FUNCTIONING OF COMMITTEES—AN APPRAISAL

The working of legislative committee seems to leave much to be desired. Legislative financial control has become more nominal than real. The Estimates Committee deals more with then economy and efficiency through administrative reforms and reorganization of several departments keeping in view direct reduction in expenditure. The PAC deliberations are based on a post-mortem examination of reports produced through the audit, sometimes relating to some distant past rather than with matters which could make an impact on the current financial performance. So it is a check rather than an effective control. Ashok Chanda who himself had been India's Comptroller and Auditor General, observed. "The effectiveness of the committee is largely determined through the thoroughness with which the audit examination has been mannered, likewise the value of audit criticism depends on the support it receives from the committee. Not only are the functions of these two authorities interrelated, but there is a measure even of interdependence in their relations. This is accentuated through the fact that through far, the bulk of the committee's inquiries are concerned with points which the Auditor-General raises." The PAC is not vested with any executive power, and its function is limited to a scrutiny of public expenditure.

The Estimates Committee is seized with the question of suggesting possible economies constant with the policies underlying the estimates presented to the Parliament. The ultimate success of the committee, though, rests on the influence it exercises on the government in its long-term thinking and planning. This, in turn, demands that the committee creates constructive and farsighted suggestions. According to Ashok Chanda, "The emphasis on a review of the policies of government and of the structure of departmental organizations, to the relative exclusion of a detailed scrutiny of estimates, has considerably altered the character and purpose of the committee.” The committee is arrogating to itself a role, which constitutionally is that of the house.

A thorough examination of working of the public enterprises through the COPU is the best accessible device of control over these enterprises through the Parliament. The COPU keeps the Parliament duly informed about their performance and how monies voted through it are, infect, appropriated. Through the COPU the administration comes in direct get in touch with the Parliament. The COPU has done some useful work. In its tone, temper and manner of working, it is not dissimilar from the Estimates Committee and the Public Accounts Committee. But the advantage lies in the fact that it has been able to provide enough time to the revise of Public Undertakings because it is concerned exclusively with them. In the course of examination of causes and investigation of troubles and issues the Committee has, from time to time, made some specific suggestions to the government and they have been found to be quite useful. It has, hence, contributed towards improving the performance and profitability of these enterprises.

REVIEW QUESTIONS

- Trace the development and development of executive control over expenditure in India.
- Discuss the duties of the Finance Ministry.
- Outline the organisation and functions of Ministry of Finance.
- Describe the historical background and constitutional provisions of legislative control.
- Explain and evaluate the legislative control over public expenditure.
- When did the thought of Public Accounts Committee originate in India? What was its rationale?
- What are the vital functions of Public Accounts Committee?

CHAPTER 7

ACCOUNTS AND AUDIT

STRUCTURE

- Learning objectives

- Role of the comptroller and auditor general (CAG)
- Accounting system in India
- Auditing system in India
- Review questions

LEARNING OBJECTIVES

After reading this unit, you should be able to:

- Understand the origin and constitutional position of CAG.
- Explain the differences flanked by Commercial and Government Accounting.
- Explain the meaning and importance of audit.
- Describe the differences flanked by Internal and Statutory audit.

ROLE OF THE COMPTROLLER AND AUDITOR GENERAL (CAG)

ORIGIN AND CONSTITUTIONAL POSITION OF CAG

Origin

Finance, Accounts and Audit are as old as history itself. History bears out that a good accounts and audit organisation existed in ancient India. Kautilya in his well-known Arthasastra gives an elaborate account of the accounting system that existed in the Mauryan period. According to the Arthasastra, "In the Mauryan policy, the final authority, in the matter of Finance, was the King; one of whose daily duties was to attend to the accounts of receipts and expenditure. Each Minister was responsible for the finance of his department and each department had its own accountant, treasurer and others. The Collector General was the head of the Finance Department. Below him was the special commissioner (Pradeshtara), who was a type of Government Auditor checking District and Village group account, in addition to being in charge of collecting sure types of revenue. The accounting and financial year closed on the last day of Ashadha".

Likewise, Gupta rulers introduced more elaborate and orderly system of accounts and audit throughout their rule. According to Ramachandra Dikshitar "The accounts were maintained, as throughout the days of their precursors, the Mauryas, and were submitted periodically for audit and approval. This is made clear to us through the term PATYUPARIKA. This may be translated broadly as corresponding to the modern Accountant General. The Accountant General who presided over the accounts department was responsible to the Council of Minister for his acts. It is apparent that there was an elaborate Department of Accounts in the Gupta time.” Likewise, the medieval rulers, viz. Sultans and Moghuls, laid proper stress on collection of revenue and conduct of audit. The Moghuls vested greater authority in their financial chief, through naming him as the Vazir or Dewan.

Although the ancient and medieval administrations recognized a coherent account and audit organisations, it went into decay, throughout the period of later Moghuls. Subsequently, it was the British, who introduced a proper system of accounting and auditing. This system is being followed, through and large, in our country today. In 1858, when the East India Company’s administration was taken over through the Crown, a complementary post of Accountant-General at the India office was created to prepare the accounts of the expenditure incurred in England. Simultaneously, an independent Auditor was appointed through the Crown for the audit of these accounts. This arrangement was, though, shortlived. In I860, both accounting and auditing functions were amalgamated and placed in charge of the Accountant-General to the Government of India, who was designated as ‘Auditor General’.

The statutory recognition of the Auditor General came, though, only in 1919, with the introduction of Constitutional Reforms. He was made independent of the Government of India and was appointed through the Secretary of State and held office as the administrative head of the Indian Audit Department, throughout his Majesty’s pleasure. The Government of India Act 1935 gave further recognition to the importance and status of this office. Thereafter, his appointment was made through His Britannic Majesty and the circumstances of his service were also determined through His Majesty-in-Council. His duties and powers were prescribed through rules made under the order of His Majesty-in-Council. His salary, allowances, and pension were made chargeable on the revenues of the Federation. He could be removed from office only in the same manner and on the same grounds, as a Judge of the Federal Court.

With the incorporation of the Government of India Act 1935 in the Independence Act 1947, the authority of the Auditor-General was further enhanced and the auditor of the Indian accounts in United Kingdom was placed under his administrative control. With the subsequent integration of the princely states in the federal structure of the Indian Union, his audit responsibility was extended to the whole of India. The Constitution Act, 1950, redesign Ted the Auditor General as Comptroller and Auditor General and made him, along with the Judges of the Supreme Court, an financial administration of India, whether in the States or the Union, should come under the coordinating authority of a single officer of Constitution, the Comptroller and Auditor General.

Constitutional Position of CAG

The Constitution has installed the Comptroller and Auditor General (CAG) as a high independent statutory authority. The CAG is the one dignitary, who sees on behalf of the Legislatures that the expenses voted through them are not exceeded or varied and that the money expended was legally accessible for and applicable to the purposes to which it has been applied. Nothing can fetter the CAG's discretion or judgment in any manner on matters which he/she may bring to the notice of the Legislatures in the discharge of his/her duties. The oath of office under the Constitution requires him/her to uphold the Constitution and the laws and to discharge the duties without fear or favor, affection or ill-will.

For the purpose of securing the highest standards of financial integrity of the administration and watching the interest of the tax-payer and also for purposes of Legislative control, the Constitution safeguards the independence and freedom of the Comptroller and Auditor General in the following ways.

- Article 148 of the Constitution lays down that the Comptroller and Auditor General of India would be appointed through the President through warrant under his hand and seal. The CAG will hold office for a period of six years or till he attains the age of 65, whichever is earlier. And he can be removed from office only in the same manner and on the same grounds as a Judge of the Supreme Court i.e. through impeachment in Parliament.
- To further ensure that the Comptroller and Auditor General cannot be influenced through the Executive, the Constitution gives, as per Article 148(3) that the salary and other circumstances of service of the Comptroller and Auditor General are such as determined through law and cannot be varied to his disadvantages, after his appointment.
- The Comptroller and Auditor General is debarred through Article 148(4) from holding any office either under the Government of India or the State Governments, after he retires from the office of the Comptroller and Auditor General.
- Furthermore, as per Article 148(6) all salaries, allowances and pensions payable to or in respect of persons serving in that office, shall be charged upon the Consolidated Fund of India.
- The Comptroller and Auditor General is the Administrative Head of the Indian Audit and Accounts Department. His administrative power will be governed through rules made through the president, in consultation with the former.

Therefore, the Constitution/assures to the Comptroller and Auditor General, constitutional independence and has also placed him beyond fear or favor of the Executive, whose transactions he is expected to audit.

DUTIES AND POWERS OF THE CAG IN REGARD TO ACCOUNTS AND AUDIT

Accounting Duties

The duties and powers of the Comptroller and Auditor General have been prescribed through the Comptroller and Auditor General's (Duties, Powers and Circumstances Service) Act 1971 as required through Article 149 of the Constitution of India. Under the Act, it is the responsibility of the Comptroller and Auditor General to audit all expenditure and receipts of the Government of India, the State Governments and of the Union Territories. He is also empowered to audit the expenditure and receipts of bodies or authorities considerably financed from Union or State revenues in the form of grants or loans.

As per Section 10 of the CAG (DPC) Act 1971, it is the responsibility of the Comptroller and Auditor General to compile the accounts of the Union and of each (CAG) State, and prepare the Finance Accounts. Again, it is the duty of the Comptroller and Auditor General to prepare, from the accounts, Appropriate Accounts, showing under the respective heads, the annual receipts and disbursements for the purpose of the Union, of each State and of each Union Territory having a Legislative Assembly. These accounts (i.e. Finance Accounts and Appropriation Accounts) are to be submitted to the President or Governor of a State or Administrator of the Union Territory, as the case may be.

He also gives the necessary information to the Union and States in the preparation of their Budgets (i.e. Annual Financial Statement). The functions of the Comptroller and Auditor General, in brief, in so far as accounts are concerned, are mainly:

- the prescription of forms in which accounts are to be kept in the Union and of the States;
- preparation and submission of Finance Accounts and Appropriation Accounts to the President/Governor/Administrator of Union Territory as the case may be, and
- providing information to Union/State Governments for preparation of their annual budgets.

Auditing Duties

The real duty of the Comptroller and Auditor General is that of an auditor. The primary audit function is to verify the accuracy and completeness of accounts; to secure that all financial transactions viz., receipts and payments are properly recorded in the accounts, correctly classified and that all expenditure and disbursements are authorized and vouched and that all sums due, are recorded regularly in accordance with the demands and brought into account. He/She acts as a watchdog to see that the several authorities under the Constitution function in regard to financial matters, in accordance with the Constitution and the laws of Parliament and appropriate Legislatures and Rules and Orders issued thereunder. As per the CAG (DPC's) Act, 1971 the auditorial functions of the Comptroller and Auditor General are as follows:

- To audit all receipts into and expenditure from the Consolidated Fund of India and of each State and of each Union territory, having a Legislative Assembly and to ascertain whether the money shown in the accounts as having been disbursed were legally accessible for and applicable to the service or purpose for which they have been applied.

- To audit all transactions of the Union and of the States relating to Contingency Funds, and Public Accounts.
- To audit all trading, manufacturing, profit and loss accounts and balance sheets and other subsidiary accounts kept in any department of the Union or of a State; and in each case to report on the expenditure, transactions or accounts so audited through him.
- To audit receipts and expenditure of bodies or authorities considerably financed from Union or State revenues.
- To audit the accounts of Government, Companies and Corporations recognized
- Through or under the Law of Parliament, or in accordance with the provisions of respective Legislations.
- To audit account of bodies or authorities through request.

In connection with the discharge of the auditorial duties, the Comptroller and Auditor General can inspect any office of accounts under the control of the Union or a State, including treasuries and offices responsible for keeping initial or subsidiary accounts. In short, the Comptroller and Auditor General is responsible for the audit of the accounts of the Union and of the States and of bodies considerably financed from Union or State revenues. Further, he/she audits the accounts of companies and corporations and of autonomous authorities, whose audit has been entrusted through law to him/her public interest. In the, performance of the duties, he/she is assisted through the Indian Audit and Accounts Department.

OTHER DUTIES OF CAG

Besides the duties and functions relating to the auditing and reporting upon the accounts of the Union, of the States and of the Union territories with Legislature, the comptroller and Auditor General may be entrusted with duties and functions in relation to the accounts of any other authority or body, as may be prescribed through or under any law made through Parliament. The Comptroller and Auditor General’s additional duty at present, is to undertake audit of companies, the Comptroller and Government companies. In the case of Government companies, the Comptroller and Auditor General may comment upon or supplement the report of the professional auditors. Also, his/her duty involves rendering assistance to the Public Accounts Committee in its functions.

ROLE OF CAG: AN APPRAISAL

The Constitution of India assigns an independent and significant position to the Comptroller and Auditor General to perform the duties without fear or favour. It has provided adequate safeguards for his/her independence from the Executive. The office of the Comptroller and Auditor General of India is created through the Constitution itself. It has perpetual subsistence like other Constitutional organs of the State viz., the Supreme Court, the High Courts and the Election Commission. The Comptroller and Auditor General is an officer of the Constitution and not an officer of Parliament, even though he/she exclusively serves Parliament and State. Legislatures. Therefore, the Comptroller and Auditor General occupies a unique place in Indian democracy.

Appointment, Tenure and Removal of CAG

The Constitution guarantees the independence of the Comptroller and Auditor General through prescribing that he/she shall be appointed through the President of India through warrant, under his hand and seal and shall not be removed from office except on the ground of proved misbehavior or incapacity. In a democratic set-up, independence in adequate measure is an indispensable necessity for this constitutional functionary to perform his/her duties undeterred. A.K. Chanda, a former Comptroller and Auditor General, has argued in favour of autonomy to maintain the dignity, and independence, detachment of outlook and fearlessness necessary for a fair, impartial and dispassionate assessment of the actions of the Executive in the financial field".

As in the case of a Judge of the Supreme Court, the Comptroller and Auditor General can be removed from office only on two grounds—proved misbehavior or incapacity. The address necessity be presented through both houses in the same session, and special majority is obligatory in each house for the passing of the resolution. The procedure for presentation of the address, investigation, and proof of the misbehavior and incapacity is to be decided through Parliamentary legislation. Therefore, the removal procedure appears to be a very hard procedure and service as an effective safeguard against executive interference.

Conditions of Appointment

The Constitution guarantees his/her salary and other circumstances of service, which cannot be varied to his/her disadvantage after his/her appointment. Also, the salary, and allowances of the Comptroller and Auditor General, shall be charged on the Consolidated Fund of India. Interference with the Comptroller and Auditor General's function is likely, if the salary and conditions of circumstances of service are left to the discretion of the Executive. Again, even in the event of Parliamentary displeasure with a Comptroller and Auditor General, his/ her salary, pension or age of retirement will not remain within the competence of Parliament to change, if it so wishes to penalize him/her. On his/her retirement, resignation or removal, the Comptroller and Auditor General is prohibited from holding any office under the Government of India or under the Government of the State. The purpose is to keep the incumbents immune from allurement of getting favors from executive, who in turn might influence his/her actions or decisions in office, prior to retirement. Indirectly, this provision strengthens the hands of the incumbents in creation fearless assessment of executive actions. In actual practice, the spirit of this provision does not appear to have been strictly followed. The Constitution has provided that salaries, allowances and administrative expenses of the Comptroller and Auditor General be charged upon the Consolidated Fund of India. Unlike the other expenses of the Government, his/her expenses will not be notable in the budget. Hence, his/her action and official conduct is planned to be excluded from the scope of Parliamentary discussion and vote. The Constitution has therefore accorded a very strong protection against Parliamentary interference with the working of the Comptroller and Auditor General's organisation.

Duties and Powers

Parliament has prescribed the duties and powers of the Comptroller and Auditor General through enacting the Comptroller and Auditor General's (Duties, Powers and Circumstances of Service) Act 1971. With the separation of accounts from audit in sure departments of Union Government, the Comptroller and Auditor General had ceased to be responsible for maintaining the accounts of Food, Rehabilitation,

Supply Departments, Lok Sabha and Rajya Sabha Secretariats, since separate accounts offices were in subsistence for them. In 1976, the Government of India took on accounting functions under its own administrative Ministry/Department with the result that separation of accounts from audit in Central Government became complete. But the responsibility for preparing annual accounts separately for each of the State Governments and Union territories having Legislative Assemblies and to submit them to the Governor or Administrator respectively remains with the Comptroller and Auditor General. The combination of auditing functions in one authority, though justified on grounds of economy, is contrary to the principles of independence of Audit. It amounts to creation the Comptroller and Auditor General partly responsible to the Executive and Legislature. He/She becomes answerable to Parliament and Legislature for his/ her accounting duties, which is an executive responsibility. Moreover, the accounting authority will hesitate in publishing in its Audit Reports, major instances of accounting irregularity arising out of the accounts compiled through itself. To that extent, auditing functions would suffer.

The Constitution prescribes that the Comptroller and Auditor General is the authority to prescribe the forms in which the accounts of the Union and of the States shall be kept. The purpose of having a centralized system of accounts is primarily to ensure uniformity and economy. Moreover, the technical expertise of Comptroller and Auditor General in accounting matters of the Union and States is to be taken advantage of through the Government in the preparation and presentation of Annual Budget. So, the provision has its own advantages. It entrusts the Comptroller and Auditor General with a very significant responsibility.

Audit Reports

The Constitution has prescribed the procedure to be followed through the Comptroller and Auditor General for presentation of his/ her reports. His/ her reports, in regard to the Union Government accounts, shall be submitted to the President. And the accounts of the State Government shall be submitted to the Governor of the State. His/ Her responsibility thereafter ceases. But it becomes obligatory for the President/ Governor to cause them to be laid before the House of Parliament/ State Legislature respectively. He/She submits three Reports viz., Audit Report, on Finance Accounts, Audit Report on the Appropriation Accounts, and Audit Report on the Commercial and Public Sector Enterprises and Revenue Receipts on Union and State Governments respectively. The Constitution does not prescribe any form or guidelines for the contents of the Audit Report of the Comptroller and Audit General. It has therefore been left with the Comptroller and Auditor General, the complete freedom and discretion to decide the form, the materials and the contents of the reports.

Limitations

Inspite of the several safeguards provided through the Constitution to maintain the independence of Comptroller and Auditor General from the Executive and Parliament, his/her independence appears to be limited through four factors viz., (a) restraint of the Executive on his/ her budgetary autonomy (b) block of control over staff (c) indirect accountability to the Finance Ministry of the Union and the Finance Department of the State Government for handling accounting duties (d) absence of direct access to Parliament (unlike the Attorney General) in defense of his/her official conduct, if and when questioned on the floors of Parliament.

To conclude, notwithstanding these limitations, the Comptroller and Auditor General plays a unique role in Indian democracy, through upholding the Constitution and the laws in the field of financial administration. He/ She is neither an officer of Parliament nor a functionary of Government. He/She is one of the mainly significant officers of the Constitution and his/her functions are as significant as that of Judiciary.

ACCOUNTING SYSTEM IN INDIA

ACCOUNTING: DEFINITION AND IMPORTANCE

The word accounts in the financial sense, has been defined as statements of facts relating to money or things having money value. The facts that are incorporated in the early stages of civilization, the number of transactions to be recorded was so small that each businessman was able to record and check for himself/herself all the transactions. But with the growth of trade, it became hard for him/ her to know from the records, how she/he stood in relation to his/her customers and whether her/ his business was profitable or not. This gave rise to the maintenance of accounts on a double-entry basis, which was helpful in the preparation of profit and loss account and balance sheet of the business. The procedure through which these ends are effected is described "accounting."

Accounting is a discipline which records, classifies and summarizes data and presents it in a convenient form to several stages of management in an organisation for decision-creation purposes. It helps managers to prepare their budget plans realistically so that the expenditure could be watched against the budget allocation, and corrective action could be taken, wherever necessary. It also helps outsiders i.e. shareholders/government, to know the working of the business firm, through presenting data about its activities, profit or loss and its assets and liabilities.

In government, accounting gives information for the preparation of annual budgets. It helps budget planners to determine, in advance, the taxes to be levied for meeting the committed expenditure, or to reduce the expenditure, wherever possible. It gives information to managers about the expenditure involved annually, on pay, allowances, materials etc. and also the expenditure incurred on Plan Schemes. It also gives information concerning expenditure incurred on functions, programmes, activities, for the speedy development of performance budgeting in all departments of government. It further helps in exercising proper financial control and observance of rules and regulations through the several authorities. Its main purpose is to give timely information to several stages of management, for taking proper decisions in respect of their areas of operations and for monitoring the performance of activities against their physical targets and also the expenditure against the budget, so as to enable the government to take corrective action, wherever measured necessary.

PRINCIPLES AND METHODS OF GOVERNMENT ACCOUNTING

The principles of commercial and government accounting differ in sure essential points. The main function of a commercial concern is to produce goods and sell them to earn a profit. On the other hand, the main function of government, is not to create profit but to govern the country and administer the several functions in the best way possible in the interests of the society at large. A commercial concern deals primarily with the utilization of capital for the purpose of creation a profit. It is interested in seeing at intervals, how it stands in relation to its debtors and creditors, whether it is gaining or losing, what are the sources of its gain or loss. In order to obtain ready answers to these questions, the concern has to keep a system of detailed accounts. In respect of each person dealt with, and each department of its activities, it maintains a separate account, so that the result of the transactions in each case may be ascertained. Through preparing the manufacturing, trading and profit and loss accounts and balance sheet, the concern is able to know the profit earned or loss incurred throughout the year.

It is a usually accepted practice in the commercial world to maintain account books on the double entry system. The double entry system is based on the fact that in every transaction, two parties or accounts are involved—one giving and the other getting. Under that system, every transaction requires two entries in the books, one against the party or account giving and the other against the party or account which is getting. The activities of a government, on the other hand, are determined through the needs of the country. If the activities to be accepted out, throughout the coming years, are recognized, it becomes easier to determine the funds required to carry out those activities. Government accounts are, so, intended to enable the government to determine, how much money it needs to collect from the tax-payers in order to maintain its activities. The classification of transactions in government accounts is determined firstly through the administrative classification of the activities and secondly through the classification of the nature of the transactions. The government accounting is, so, quite elaborate and is kept on a single entry basis.

SEPARATION OF ACCOUNTS FROM AUDIT

Accounting and auditing are interrelated but have independent functions. For reasons mainly of economy, these have been traditionally combined under one authority. From time to time, though, attempts have been made to separate accounting from auditing as in the case of railways, defense, food, rehabilitation and supply. In 1971, the Comptroller and Auditor General's (Duties, Powers and Circumstances of Service) Act was passed, which visualized the need for separating accounts from audit.

Section 10 of the Act empowered the President, after consultation with the CAG, to relieve the Comptroller and Auditor General from the responsibility of compiling the accounts of any department of the Union Government. A scheme for the separation of accounts from audit was approved through the Government of India in June 1975. An ordinance was issued through the President, which was followed through passing an Act, which amended the Comptroller and Auditor General's (DPC) Act 1971, thereby relieving him from the responsibility of compiling accounts of Ministries/Departments of Government of India. He, though, still performs the accounts and audit functions in each state.

Advantages of Combined Audit and Accounts

Continuance of combined audit and accounts under one functionary has been justified on the following thoughts:

- Accounting and audit functions are interrelated. The pre-audit of claims before admission for payment, the examination of contract documents, etc. with reference to the financial principles and rules is essentially an audit procedure. So, the combination of the two functions is not wrong.
- An accounts organisation, independent of the administration, is a necessity to ensure that the internal accounting organisation is not coerced through the administration to admit questionable claims, overlooking irregular practices.
- Under the existing practice, sure accounting responsibilities have been imposed on the Comptroller and Auditor General. Consequently, arrangements will have to be made through him for the consolidation of departmental accounts and the compilation of Finance Accounts of the Central and State Governments as a whole. The co-coordinating role will imply that the uniformity in accounting principles and processes in the units has to be maintained.

- The Constitution has provided for a single Comptroller and Auditor General, unlike other Federal Constitutions. Hence, it would be better to keep accounts and audit with the Comptroller and Auditor General.

Disadvantages of Combined Audit and Accounts

The vital disadvantages of the combined system are as follows:

- It violates the fundamental spirit behind the provisions of the Constitution and of the CAG Act of 1971, which expects that the duties of Comptroller and Auditor General should essentially be auditorial.
- Combination of audit functions with payment and account functions brings the Comptroller and Auditor General under the indirect control of the Finance Minister. Questions tabled in the Houses of Parliament pertaining to his accounting duties are answerable through the Minister of Finance
- Federal structure has been prescribed through the Constitution with autonomy to the states. With the state accounts handled through a functionary directly under the President, entrusting accounting duties to the Comptroller and Auditor General would lead to the loss of the accounting autonomy of the states.
- The combined accounts and audit offices function with less speed in the performance of their accounting duties, i.e. in the timely payments of dues, such as salary, pension, provident fund, gratuity etc.

The disadvantages listed out above are not so great as to justify opposition to the separation for all times to come. The mere fact that separate accounts organisations of Defense, Railways, Lok Sabha/Rajya Sabha Secretariat and the separated Ministries of Works, Housing and Supply etc. are functioning with efficiency, it dispel the fears enumerated. In fact, the disadvantages arising out of combined accounts and audit organisations are more than the advantages accruing out of it.

Advantages of Separation or Departmentalization of Accounts

Departmentalization of accounts has several advantages. It establishes a definite accountability on the decision-creation departments for the expenditure incurred through them, out of the approved budget. He, who spends, should account for the expenditure. But an executive without administrative control over its accounting machinery, will hardly be able to discharge effectively its financial and accounting responsibility. Departmentalization of accounts enables the audit department to confine its attention to audit matters in greater depth. The activity of higher audit (i.e. Efficiency-cum-Performance Audit) may get blurred, when audit is involved with routine accounting duties. Moreover, accounting duties bring the Audit Department partially under the control of the executive, whose accounts it compiles.

Separation of Accounts

Realising the rising need for separation of accounts from audit, the Government of India decided to departmentalize the accounts of the Central/Ministries/ Departments, which had been with the Comptroller and Auditor General of India. All Ministries of the Government of India including the Posts and Telegraphs Department were brought under the Scheme of departmentalization of accounts flanked by 1st April to 31st December, 1976.

DEPARTMENTALISATION OF ACCOUNTS

The scheme of Departmentalization of accounts introduced from 1st April, 1976, is in character and method dissimilar from the earlier attempts made in this regard. The main objective behind this scheme was that in view of the manifold augment in Government expenditure and the need to implement effectively the developmental plans, management accounting should be properly developed as an integral part of each Ministry/Department It was realized that to achieve this objective, the externality of the accounting system should be eliminated and there should be a vertical functional integration, coupled with horizontal administrative integration at each stage of management. Accordingly, the Departmentalization of accounts involved not only relieving the Comptroller and Accountant General of the responsibility of compilation of accounts but also taking over mainly of the payment and receipt functions from the Treasuries.

The broad characteristics of the Scheme of Departmentalization are detailed below:

- Each Ministry functions administratively under a Secretary, who is assisted through an Additional Secretary, a Joint Secretary, and Under Secretaries supported through subordinate officers. Separately from the Headquarters set up, every Ministry
- The Comptroller and Auditor General was relieved of the responsibility of compiling and keeping the accounts of transactions relating to the Departments of the Ministries. Payment functions discharged through the treasuries were also taken over through the Departments. According to the practice, prior to departmentalization of Accounts, the main Ministry and the subordinate offices used to draw funds through means of presenting bills in treasuries. The treasuries used to render accounts to the respective Accountant Generals, who

compiled the monthly accounts. Each Accountant General rendered a monthly account of Central Government transactions to the Accountant General, Central Revenues in Delhi, for consolidation and preparation of civil accounts.

- The Secretary of each Ministry is designated as the Chief Accounting Authority responsible for all transactions of the Ministry and its Departments. This responsibility is discharged through the Integrated Financial Advisor (IFA) of the Ministry. The Secretary has the over-all responsibility for the functioning of the accounting and payment set-up and is responsible for certification of monthly accounts.
- The Integrated Financial Advisor performs the following duties, on behalf of the Chief Accounting Authority. He/She will be responsible for:
    - The preparation of the budget of the Ministry and its Departments in coordination with the Heads of Departments concerned and sharing of the budget allotment in the middle of the several wings/ departments of the Ministry. Control of expenditure will also form a part of his/ her responsibility.
    - Arranging payments to autonomous bodies, corporations, authorities, and also grants-in-aid, loans etc.
    - Arrangements for creation payments through the Pay and Accounts offices of pay and allowances, office contingencies and miscellaneous payments.
    - Consolidation of the accounts of the Ministry as a whole, in accordance with the instructions issued through the Central Government.
    - Preparation of Appropriation Accounts for the grants controlled through the Ministry.
    - Organizing a sound system of internal check to ensure accuracy in accounting and efficiency of operation as part of management.
    - Introduction of an efficient system of Management accounting best suited to the functional necessities of the Ministry and its Departments.
- The payments relating to the Ministries/ Departments which are now made through the Bank and non-Bank treasuries, Accountant General and State Pay and Accounts Officers, will be made through the Departmental Pay and Accounts Offices.

In brief, departmentalization of accounts was done mainly with a view to enable the Ministries to exercise direct control over their expenditure and to introduce a management accounting system, so as to give relevant information to several stages of management for taking proper decisions.

REVISED ACCOUNTING STRUCTURE

The accounting system introduced through the British in the early years of this century remained more or less unchanged till April 1974. The classification in the accounting system introduced through the British, was mainly to facilitate financial and legal accountability of the Executive to the Legislature and within the Executive of the spending agencies to the sanctioning authorities. Again, the classification had secure relationship to the department in which the expenditure occurred than to the purposes for which the money was spent. The vital concern was the item on which money was spent rather than the purposes served through it. This system served well so long as the functions of the Government were limited. But with a change in the role of Government, i.e. undertaking developmental programmes for the socio-economic development of the country under the successive Five Year Plans, need was felt for bringing in necessary reforms in the system of accounts, so as to meet the challenges of development administration.

The Administrative Reforms Commission set up through the Government in 1966, to bring about reforms in administration examined the existing system of accounts and recommended in their Report on " Finance. Accounts and Audit", some changes in the system. This was done mainly in the context of introduction of performance budgeting in India. The Commission recommended that the structure of major heads of accounts should be recast to reflect broad functions and major programmes of Government. Also, the programmes, activities and projects of the several departments and organisations should be clearly recognized and the minor heads linked with these programmes suitably recast, so as to reflect these activities. The Commission also suggested that the heads of development adopted for Plan purposes should be reviewed with a view to establish a direct correlation flanked by these heads and the general accounting heads. The Commission also recommended that the Government should constitute a team composed of representatives of the Comptroller and Auditor General, the Planning Commission, the Ministry of Finance, and the Administrative Ministry concerned which should be assigned the task of drawing up a programme for the implementation of the commission's recommendations.

The Government of India accepted the suggestions of the Commission. It appointed a team of officers composed of the Deputy Comptroller and Auditor General, the Joint Secretary (Budget) of the Ministry of Finance, and a representative of the Planning Commission, to undertake a review of the Heads of accounts and the Heads of development adopted for Plan purposes. The team submitted two reports on the reforms in the structure of demand for grants. In part I of the report, it suggested that a Ministry/Department in charge of a number of separate services may present a separate demand for each of the major activities.

In part II of the Demands, details of expenditure upto the stage of major and minor heads of account may be incorporated. In part III of the Demands, further details may be given about the provisions made in part II for minor heads and for activities/schemes/organisations under minor heads. The team submitted the second report in November 1972. It proposed a five tier classification structure.

The team mentioned that the new classification would facilitate a link flanked by budget outlays and functions, programmes and activities. It would also ensure itemized control of expenditure. Also, the classification would facilitate introduction of performance budgeting. The Government of India accepted the recommendations of the team on reforms in the structure of Budget and Accounts.

A revised accounting structure was introduced through the Government of India from April, 1974. Under this scheme, a five-tier classification has been adopted, namely Sectoral Major Head, Minor Head, Sub-Head and Detailed Heads of account. Sectoral classification has grouped the functions of government into three sectors, namely. General Services, Social and Community Services and Economic Services. General Services Sector comprises services indispensable to the subsistence of an organized state, such as Police, Defense, External Affairs, Fire protection etc. This sector comprises Organs of State (Parliament), Head of State, Judiciary, Fiscal and Administrative Services and Defense Services.

Social and Community services sector covers programmes and activities relating to provision of vital social services to consumers, such as Education, Medical Relief, Housing, Social security and Welfare and Services required for community living such as Public Health. Urban Development, Broadcasting etc. Economic Services Sector comprises programmes and activities in the fields of Production, Sharing, Trade, Regulation etc. In the new scheme of accounts, a Major Head is assigned to each function, and a Minor Head is allotted to each Programme. Under each Minor Head, there would be sub-heads assigned to activities/schemes/organisations sheltered through the programme. Major and Minor Heads classification is common to Union, States and Union territories Governments. Under the new scheme, the object classification has been retained and placed as the last tier. It is meant to give item-wise control over expenditure and to ensure financial control.

The revised accounting structure in conditions of programmes, activities, and projects establishes adequate links flanked by Budget and Account Heads-

(i.e. Major Head, Minor Head and Sub-Head) and the Plan Heads of development. It helps in obtaining information of the progressive expenditure incurred in plan programmes and projects. It also helps in the speedy implementation of performance budgeting. Further, it also helps in monitoring and analysis of expenditure on programmes activities/ projects to perform the management functions effectively.

MANAGEMENT ACCOUNTING IN GOVERNMENT

According to American Accounting Association “Management Accounting is the application of appropriate techniques and concepts in processing historical and projected economic data of an entity to assist management in establishing plans for reasonable economic objectives and in creation of rational decisions with a view toward those objectives.” Management accounting involves collection and presentation of all such information which can be of help to management in the preparation of budget plans for the organisation. It helps in proper monitoring and evaluation of performance of the activities, as compared to the budget plan in conditions of financial expenditure and the corresponding physical accomplishments. Its purpose is to give timely information to several stages of managements to facilitate decision-creation, for efficient and economical attainment of their tasks.

Management accounting encompasses financial accounting, cost accounting and all characteristics of financial management. It involves not only collection of information from financial records but also from cost records. In a system of management accounting, information has to be composed from several sources inside and outside the organisation and presented to management for taking decisions. A good management accounting system should give timely accounting information to several stages of management, for a continuous review of the progress. of expenditure as related to the budgeted funds and the planned tasks. It should also facilitate the working of the scheme of performance budgeting.

Management accounting varies from organisation to organisation depending on its objectives, organizational structure, and the information necessities at several stages etc. In Government, it is hard to prescribe a standard system of management accounting, applicable to all departments of Government, as the functions of each department vary from one another. It is necessary, so, to evolve a management accounting system suited to the department, keeping in view its objectives, organizational structure, information necessities etc. Again,' management accounting system, once introduced, should be reviewed periodically to cope with the changing necessities of that scrupulous department.

An Advisory Committee had been appointed, in 1976, through the Government of India under the Chairmanship of the Finance Minister, to consider and recommend management accountancy concepts to suit the necessities of dissimilar Ministries/ Departments. The Committee was also required to create recommendations concerning management information system necessary to be developed for the purpose. Very little progress has, though, been in this direction due to several constraints.

The constraints in developing a system of management accounting in government have to be recognized. Government accounting, is done on a cash basis (not double entry basis) which creates it hard to know the whole cost assignable to an activity. Again, the present structure of financial accounting is not conducive to serve the purposes of management accounting. The existing classification of accounts does not allocate cost to a 'cost-centre' or responsibility centre so as to evaluate actual cost against standard cost. Although the new classification structure developed for performance budgeting in conditions of functions, programmes, activities had helped in monitoring expenditure on a programme or activity, the classification still needs to be connected with cost-centers or responsibility centers for speedy development of management accounting in Government.

It may be concluded that the, recent financial reforms introduced in the Government of India, namely, revised accounting structure, departmentalization of accounts, performance budgeting, Integrated Financial Advisor Scheme etc. are all planned to facilitate the early introduction of management accounting in government. The reforms already started should be accepted forward, so that the management accounting system developed in a Ministry/Department, could give timely information to several stages at management for speedy decision-creation.

AUDITING SYSTEM IN INDIA

AUDITING: DEFINITION AND IMPORTANCE

The world Audit is derived from the Latin word Audile to hear. Originally, the accounting parties were required to attend before the auditor, who heard the accounts. In the early stages of civilization, the methods of accounts were so crude and the number of transactions to be recorded so few that each individual was able to check for himself/herself all his/her transactions. But soon with the establishment of empires, a system was recognized to record account transactions and audit them. The person whose duty, it was to check such accounts came to be recognized as the Auditor.

An audit is an examination of accounting records undertaken with a view to establishing, whether or not they correctly and totally reflect the transactions to which they purport to relate. Its purpose is to see that expenditure has been incurred with the sanctions of the competent authority and applied for the purpose for which it was sanctioned. It should be duly supported through vouchers, as a safeguard against fraud and misappropriation.

Audit is an instrument of financial control. In its relation to commercial transactions, it acts as a safeguard, on behalf of the proprietor, against extravagance, carelessness or fraud on the part of the proprietor's employees in the realization and utilization of his/her money or other assets. It ensures on proprietor's behalf that the accounts maintained truly, represent facts and that expenditure has been incurred with due regularity and propriety.

The financial transactions of a government need to be likewise watched. The agency employed for the purpose should be independent from the employees of Government, who are entrusted with the realization and utilization of public money or other assets. This task is entrusted, in India, to the Indian Audit and Accounts Department. So far as its audit duties are concerned, the position of the Indian Audit and Accounts Department in relation to government transactions, is to a large extent, similar to that of an auditor. In this context. Parliament/ Legislatures may be regarded as the shareholders of the Government concern and the Executive Government as its directors. The object of this concern is, though, not profit- creation.•

Audit is one of the four pillars of democracy viz., (i) Parliament (ii) Judiciary (iii) Press and (iv) 'Audit. Firstly, Parliament is the mainly significant organ of democracy. It is composed of people's representatives, elected on the basis of adult franchise. The members belonging to the majority party in Parliament form the Government. All laws necessary for the running of the Government have to be passed through the Parliament. Again, it votes taxes which give government the possessions, necessary for running the administrative machinery and also vote's funds for meeting the expenses. Secondly, judiciary and the press are the other two pillars which are necessary for administration of justice and functioning of a healthy democracy.

Lastly, audit is a vital instrument of ensuring effective supremacy of Parliament over the executive. Parliamentary control consists not only in voting suppliers' and approving the imposition of taxes but also in ensuring that actually the funds have been applied to the purpose for which these were voted.

Audit is a valuable aid to administration. In all countries, audit is not just tolerated as a necessary evil but is looked upon as a valued ally, who brings to notice procedural and technical irregularities and lapses on the part of individuals, whether they may be errors of judgment, negligence or acts and intents of dishonesty. The complementary roles of audit and administration are now accepted as a fact, being essential for toning up the machinery of governments In the ultimate analysis, audit.

DEVELOPMENT OF AUDITING IN INDIA

The development of auditing in India, as well as in other countries, has been a gradual procedure. It has been closely related to the activities undertaken through the government, the internal control and management systems accessible in government departments. In the pre-war era, the main functions of government were collection of revenue, maintenance of law and order, defense and execution of public works of sure types. Few governments undertook commercial activities. In such a situation, the function of audit was largely one of regularity and compliance audit. The principal components of audit in the pre-war era were (a) audit against budget provisions (b) audit against sanctions (c) audit of accounts and appropriations (d) expenditure audit and (e) propriety audit. Audit against budget provisions and against sanctions constituted what was recognized as compliance, or regularity audit [See Section 22.5 (i)]. The highest form of audit within the traditional framework, was measured to be propriety audit. A transaction, which was otherwise in order and in conventionality with rules and regulations, could still of objected to on the ground that it breached broad' concepts of financial ethics.

In the post-war era, the welfare state had to undertake many socio-economic, commercial and industrial programmes to speed up development and improve the quality of life of the people. Correspondingly, audit had to shift its emphasis so that it was in a position to report to Parliament, whether or not these programmes/activities had achieved their objectives. New areas of audit had to be sheltered and new techniques had to be developed. With rising activity, government departments and agencies had to build up their own systems of internal control.

The transition from the traditional kind of audit to the audit of economy, efficiency and effectiveness of activities (the three E's audit) was achieved, through an intermediate stage of value for money audit, which sheltered the economy and efficiency characteristics. Broadly, it can be said that economy audit is aimed at ensuring that the activities are undertaken and completed at the lowest possible cost.

Efficiency audit is concerned with ascertaining that an activity is completed according to a pre-determined output to input ratio and according to a predetermined time table. In the audit of effectiveness of programmes, it is necessary to determine whether the objectives for which the programmes were undertaken, have been achieved and whether the programmes had the planned effect on the social and economic life of the people. Therefore, broadly, it can be stated, that in the earlier stage, traditional audit was concerned with economy, at the intermediate stage, it Was concerned with economy and efficiency and that today it is concerned with economy, efficiency and effectiveness.

As already mentioned, the development of government auditing in India has been a gradual procedure, coinciding with the changes in the functions of government. Until 1950, government audit was mainly expenditure oriented. Appropriation audit, regularity audit, sanction audit, propriety audit etc. were mannered through the Indian Audit and Accounts Department, in so far as they related to individual transactions of government. The techniques and procedures prescribed for conducting audit, through and large, fulfilled the task of transaction audit of government expenditure.

The concept and practice of audit of expenditure has undergone radical changes in the post-independent era (after 1950). Following the development of parliamentary democracy and introduction of successive Five Year Plans for national development—social, economic and industrial—massive investments have been made through the government at the centre and in the states. When the pattern of government expenditure-dimension underwent a radical and rapid transformation in the wake of successive national plans, it was felt that the scrutiny of individual transactions was inadequate, as it tended to mistake the tree for the woods. It became, so, essential for audit to ascertain whether the several development programmes and welfare activities were being properly executed and their operations mannered economically, whether they were producing the results expected of them. Hence the concept of efficiency audit was introduced to meet the changing necessities in the

Introduction of performance budgeting and functional classification in government accounting gave a new dimension to efficiency-cum-performance audit. Since 1962, when the technique of efficiency-cum-performance audit was developed, it has been applied to the transactions linked with the development programmes. The introduction of comprehensive appraisal of the public sector undertakings and development of the mechanism of Audit Boards with built-in external expertise, saw yet another extension of the technique of efficiency-cum-performance audit. In addition, audit also sheltered new areas i.e. audit of tax receipts, audit of scientific departments etc. With the shift in approaches in audit, changes have been introduced in the content and presentation of audit reports. Therefore, the development of auditing in India has been a gradual procedure, matching with the changes in the functions of government.

STATUTORY AND INTERNAL AUDIT

Statutory Audit

Statutory audit refers to the audit mannered through the Comptroller and Auditor General, through the agency of the Indian Audit and Accounts Department. As per the Constitution as well as through the CAG (DPC) Act, 1971, it is the function of the Comptroller and Auditor General to (i) audit all expenditure from the Consolidated Fund of India of the Union, of each State and of each Union Territory, having a Legislative Assembly and to ascertain whether the money shown in the accounts as having been disbursed were legally accessible and applicable to the service or purpose to which they have been applied or charged and whether the expenditure conforms to the authority who governs it and (ii) to audit all transactions of the Union and of the states relating to the contingency funds and public accounts. The Comptroller and Auditor General has been given, under the Constitution, access to the accounts of expenditure incurred against appropriations granted through Parliament. The CAG is empowered to inspect any office linked with the transactions to which his/her authority extends. -

Statutory audit has a three-fold purpose. First, it is an accountancy audit to check the accuracy of arithmetical calculations and to see that all payments are supported through receipted vouchers. In its essence, it is no dissimilar from the limited audit of private auditors. Its objects are (i) discovery of fraud (ii) the discovery of technical errors and (iii) the discovery of errors of principles. It is usually a continuous audit, but of a small percentage of transactions. Secondly, it is an appropriation audit to check the classification of expenditure, in order to create sure that the items have been charged to the proper heads of accounts and further that the appropriation for these heads have not been exceeded. Thirdly it is an administrative audit or audit of sanctions to check that expenditure has been incurred according to the rules and regulations or where not so sheltered, it has been sanctioned through the competent authority. Statutory audit, can assure the Parliament, that appropriations have been utilized in accordance with the rules and regulations and within limits specified. It can vouch for the accuracy of accounts and detect misapplication of funds, frauds, and defalcations.

Internal Audit

Internal audit, on the other hand, is internal to the organisation. Internal audit is mannered through an agency or department created through the management of the organisation. It is an integral part of the organisation and functions directly under the Chief Executive. It is in the nature of an internal service to the Executive for smooth and efficient functioning and for reviewing and improving its performance. The common objectives of an internal audit, inter-alia are to (i) check the adequacy, soundness and applicability of the systems of internal controls (Accounting, financial and other operating controls); (ii) prevent and detect frauds (iii) check on the performance-cum-efficiency audit of an operation/programme/activity of an entity as a whole, or its parts intended to dissimilar stages for any of the objective, set through the management.

Internal audit, in any organisation, does not possess the same type of independence as is accessible to the external audit, mannered through the Indian Audit and Accounts Department. There is, though, no disagreement flanked by internal and external or statutory audit. Where internal audit is adequate, the extent of statutory audit is limited to test checking of internal audit work.

KINDS OF AUDIT

The broad aim of audit is to safeguard the financial interests of the tax payer and to assist the Parliament/State/Union territory legislatures in exercising financial control over the executive. It is the function of the Comptroller and Auditor General to ensure that the several authorities set up through or under the Constitution, act in regard to all financial matters, in accordance with the Constitution and the laws of Parliament and appropriate legislatures and rules and orders issued thereunder. In order to discharge the auditorial duties entrusted through the Constitution to him/ her, the Comptroller and Auditor General (CAG) conducts several kinds of audit viz., Financial audit, Regularity audit, Receipts audit, Commercial audit, Audit of stores and stock, Performance audit etc. In the performance of this stupendous task, the CAG is assisted through the accounting authorities in several ministries and through the Principal Accounts Officers functioning in several states. Some of the characteristics of Financial audit, Regularity audit, Receipts audit, Performance audit are explained in the following paragraphs.

Financial Audit

Financial audit is the audit mannered through the Indian Audit and Accounts Department to see whether the administrative action of the executive is not only in conventionality with prescribed law, financial rules and procedures, but it is also proper and does not result in any extravagance. Financial audit does not concern itself with the audit of administrative organisations and procedures and is dissimilar from administrative audit. It is the duty or the function of the executive government to frame rules, regulations and orders, which are to be observed through its subordinate in waste, extravagance or improper expenditure, it is certainly the duty of audit to call specific attention to matters of that type and to bring the facts to the notice of Parliament. For instance, in a canal project construction, audit would not concern itself with the administrative set-up for the actual construction of the canal and whether it should pass through a scrupulous part of the country or not. These are matters of administration and no scrutiny of these processes will be done through the audit. But if it is found that the alignments had been drawn up on insufficient data, necessitating a subsequent change involving additional expenditure or that the financial results were less than what had been anticipated, then it is the duty of audit to look at the circumstances which resulted in the wrong alignments resulting in loss or avoidable expenditure to the tax payer. Audit interferes only when administrative action has serious financial implications and is not in conventionality with prescribed law, financial rules and procedures. Financial audit also comprises audit against propriety or broad principles of orthodox finance. Therefore, financial audit safeguards the interests of tax-payer through bringing to the notice of Parliament, wastage in government expenditure.

Regularity Audit

Regularity audit consists mainly in checking that the payments have been duly authorized and are supported through proper vouchers in the prescribed form. Its main purpose has been to ensure conventionality with the relevant administrative, financial budgetary and accounting rules and regulations provided for in the Constitution or the laws made through Parliament.

The objectives of audit against regularity as specified in the Audit code, inter-alia, are to ensure:

- That there is provision of funds for the expenditure, duly authorized through competent authority;
- That the expenditure is in accordance with a sanction properly accorded and is incurred through an officer competent to incur it;
- That the claims are made in accordance with the rules and in proper form;
- That all prescribed preliminaries to expenditure are observed, such as proper estimates framed and approved through competent authority for works expenditure, a health certificate obtained, where necessary, before disbursement of pay to a government servant;
- That the expenditure sanctioned for a limited period is not admitted in audit beyond that period without further sanction;
- That the rules regulating the method of payment have been duly observed through the disbursing officer;
- That payment has been made to the person and that it has been acknowledged and recorded 50 that a second claim against government on the same account, is not possible; and

- That the payments have been correctly brought into account in the original documents.

Audit against provision of funds, aims at determining that the expenditure incurred has been on the purpose for which the grant and appropriation had been provided and that the amount of such expenditure does not exceed the appropriation made. Audit, in relation to audit of expenditure, is to ensure that each item of expenditure is sheltered through a sanction of the competent authority. Audit against rules and orders is an significant characteristic of regularity audit. It ensures that the expenditure conforms to the relevant provisions of the Constitution and of the laws and rules made there under. Audit of expenditure against regularity is a quasi-judicial kind of work, performed through the audit authorities. It involves interpretation of the Constitution, rules and orders.

Receipts Audit

Receipts audit involves the audit of income-tax and custom and excise receipts at stage. From the late fifties, receipts audit has been mannered through the Indian Audit and Accounts Department.

In receipts audit, the function of audit department is to ensure that adequate regulations and procedures have been framed and are being observed through the revenue department, to secure an effective check on assessment, collection and proper allocation of revenue. Since the assessments in a revenue department are of a quasi-judicial nature, audit should ensure that the discretion used has been exercised in a judicious manner.

Performance Audit

Financial audit and Regularity audit usually involve scrutiny of individual transactions. They do not focus on the evaluation of a scheme or a programme to which these transactions relate. So, both kinds of audits have been found inadequate for an evaluation of the performance of an organisation in conditions of its goals or objectives. Ever since the Government launched Five-Year Plans, investment on a large scale has been made on developmental activities for acceleration of socio-economic development of the country. In several cases, the investments did not provide the expected returns. So, public has a right to know whether the results achieved had been commensurate with the possessions invested. The public concern has found expression in the introduction of performance budgeting in government.

The change in the thinking of government, in recent times, about the need to relate expenditure to corresponding physical accomplishments made it also to think about the functions of audit. It has been accepted that Regularity audit/Propriety audit is essential for parliamentary control of expenditure. Though, in view of the rising developmental expenditure, under the successive Five Year Plans, audit should look at the achievements of specific programmes, activities and projects in conditions of their goals or objectives. It has been felt that audit should bring out those cases where utilization of possessions has been sub-optimal. This has resulted in a serious thought being given to the need for performance audit which is also described efficiency unit.

Performance audit seeks to find out whether the possessions have been utilized efficiently through deploying them in an optimum manner. It highlights the extent to which possessions are put to productive uses. It also highlights as to what extent quantified benefits could be expected from such deployment of possessions. Although the technique of performance audit is sound and useful, there are several troubles in conducting such an audit. Firstly, performance evaluation of an activity can be made only in the light of the objectives, which is expected to achieve. Objectives spell out the results desired from an activity. Whereas inputs are easy to measure for an activity, tremendous effort is required to quantify and measure the resulting output, particularly when this output has a social context.

Secondly, according to the concept of Net Welfare, the utilization of possessions has to be optimized not only at the point where they are deployed but also at other points, where the effects of such investments are accepted. In other words, investment decisions need to be justified through the application of the technique of social cost- benefit analysis.

Thirdly, the objectives of investment are often a combination of financial and non- financial factors. There may be situations, when these objectives of public investment which are otherwise measured socially desirable, are found incompatible with immediate financial objectives. For instance, a public undertaking engaged in the production of fertilizers, may have to sell its output at a low price fixed through the government to support agricultural programmes. If the undertaking does not get adequate subsidy from government, its financial results may present a discouraging picture. The undertaking may have served a long-range national objective of achieving self-sufficiency in food production. But in the procedure, its profits get reduced considerably or it may incur losses. In situations, where the objectives act against financial performance of a public undertaking, it would not be proper to

Fourthly, performance audit presupposes a good information system. A good information system is necessary, to furnish information about what has been actually achieved and at what cost, as against what was planned to be accomplished at a scrupulous cost.

Lastly, effectiveness of performance audit would depend on how best the yardsticks of performance have been evolved. The technique of performance audit can be applied successfully in cases, where norms/standards are accessible for application. It is easier to apply in manufacturing organisations, than in the case of governmental organisations.

In India, the concept of performance audit is of recent origin. Its scope is unlimited. To conduct performance audit of public undertakings, Audit Boards have been set up. These Boards have been functioning, under the Comptroller and Auditor General, since April, 1969.

The utility of Performance audit can hardly be over-emphasized. It, though, requires expertise in identifying quantifiable objectives in government. It also necessitates framing of precise yardsticks against which the use of possessions can be evaluated. In view of these troubles, the scope of performance audit in government appears to be at present limited.

INDEPENDENCE OF AUDIT

In India, independence of the audit has been ensured through the Constitution in several ways. Firstly, the Constitution had made audit of the accounts of the Union and of the States a Union subject, through virtue of Entry 76 in the Union List under Article 246 of the Constitution. There is, therefore, a common auditor of both the Union Government as well as the States and this is a unique characteristic of the Indian Constitution.

Secondly, the Constitution gives that the Parliament shall have exclusive power to create laws on the subject of audit of the accounts of the Union and of the States. At the same time, the Constitution has not made the Comptroller and Auditor General of India an officer of Parliament or of the House of the People. In practice also, the States do not regard him as an officer of the Union but a functionary created through the Constitution for purposes of both the States and the Union Government. Therefore, the Comptroller and Auditor General of India occupies a unique place. He certifies the share of the States of the taxes composed through the Union and the amounts so certified are accepted through the State Governments without demur. He certifies the expenditure incurred through the States on public expenditure programmes initiated and financed through the Union and the Union Government accepts the figures without question. The Comptroller and Auditor General of India, therefore plays a fiduciary role in the sensitive Union-State relations.

Thirdly, the Constitution guarantees the independence of the Comptroller and Auditor General of India through prescribing that he shall be appointed through the President of India through warrant, under his hand and seal, and cannot be removed from office except on the ground of proved misbehavior or incapacity.

Fourthly, while Parliament will be competent to create laws to determine his salary and other circumstances of service, they cannot be varied to his disadvantage, after his appointment.

Fifthly, on retirement, resignation or removal, the Comptroller and Auditor General is prohibited from holding any further office either under the Government of India or under the Government of any State.

Sixthly, the salary and allowances of the Comptroller and Auditor General, the pension etc., payable to retired Auditors General and the administrative expenses of Comptroller and Auditor General's personal office, shall be charged on the Consolidated Fund of India. That is, they will not be subjected to the vote of

Lastly, the Constitution further gives that the circumstances of service of persons serving in the Indian Audit and Accounts General shall be determined through the President after consultation with him. The Constitution, therefore, gives adequate safeguards to the Comptroller and Auditor General to enable him/her perform his/ her constitutional functions, without any fear from the Executive.

An independent judiciary and an independent audit are two of the more significant elements of democracy. On them, devolves in varying degrees, the responsibility of protecting democracy from authoritarian trends and executive excesses. Our Constitution has taken, so, reasonable care to safeguard their independence.

RESULTS OF AUDIT—AUDIT REPORTS AND THEIR FOLLOW UP WITH ADMINISTRATION

The authority of Parliament and state legislature to grant supplies to be effective, will require that Parliament and legislature should assure itself that the money is spent through the executive on purposes for which it was granted. And that the expenditure incurred does not exceed the amount sanctioned through them.

The details of these are contained in the accounts and audit reports presented through the Comptroller and Auditor General for both Union and State governments. It is impossible for parliament and legislatures to look at in detail, the accounts and audit reports thereon which are technical and voluminous documents. The Houses are unable to spare the time that a proper examination requires. Parliament (Lok Sabha) and state legislatures have, so, set up a Committee recognized as the Committee on Public Accounts and have entrusted to it the detailed examination of accounts (appropriation and Finance) and audit reports thereon.

An significant function of the Public Accounts Committee is to ascertain that the money granted through Parliament has been spent through the government within the scope of the demand. This implies that the money recorded as spent against the grant, necessity not be more than the amount granted and the grant should be spent on purposes, which are set out in detailed demand. The functions of the committee extend, though, beyond the formality of expenditure to its wisdom, faithfulness and economy. When any case of proven negligence, resulting in loss or extravagance, is brought to the notice of the committee, it calls upon the Ministry/ Department concerned to explain what action, it has taken to prevent a recurrence. In such cases, it might record its opinion in the form of disapproval or pass strictures against the extravagance or lack of proper control through the Ministry/Department concerned. The Committee is, though, not concerned with questions of policy in the broad sense.

The efficient functioning of the Public Accounts Committee depends largely on the assistance given to it through the Comptroller and Auditor General and other officers. Separately from providing the vital material, audit assists the Committee in several ways. It gives notes to the members of the Committee which explain the significance of an irregularity or impropriety commented upon in the Audit report. Also, the auditors brief the members orally so that they can seek clarification and additional information in the course of oral examination of departmental witnesses. They also assist the committees in drafting reports, after considering the oral and documentary proof. They also help the Committee in keeping a watch over implementation of those recommendations, which have been accepted through Government.

The Public Accounts Committee of Parliament/State submits its report embodying the findings on the audit reports of the Comptroller and Auditor

General to Ministry/ Department for implementation. The ministries are required to inform the Committee of the action taken through them on these recommendations within a period of six months from the date of the presentation of the Report. The Committee's recommendations are usually accepted through the Government. In cases, where the recommendations of the Committee are not acceptable to the Government, the reasons for Government's disagreement are placed before the Committee.

REVIEW QUESTIONS

- Describe the duties of CAG in respect of Accounts and Audit.
- Discuss the advantages and disadvantages of the separation of accounts from Audit and its present position in Government.
- Explain the main characteristics of Departmentalization of Accounts.
- Explain the meaning and importance of audit in a democracy.
- Explain the variation flanked by Statutory audit and Internal audit.

CHAPTER 8

FINANCIAL ADMINISTRATION OF PUBLIC ENTERPRISES

STRUCTURE

- Learning objectives
- Financial autonomy and accountability of public enterprises
- Financial administration of public enterprises
- Review questions

LEARNING OBJECTIVES

After reading this unit, you should be able to:

- Explain the concept of financial autonomy and accountability in Public Enterprises (PEs).
- Describe several tiers of financial autonomy and accountability in PEs.
- Discuss the methods of ensuring financial autonomy and accountability in PEs.
- Explain the meaning 'and importance of financial administration in public enterprises (PEs)

FINANCIAL AUTONOMY AND ACCOUNTABILITY OF PUBLIC ENTERPRISES

CONCEPT OF FINANCIAL AUTONOMY AND ACCOUNTABILITY IN PUBLIC ENTERPRISES

Public Enterprises (PEs) as we all know are set up wholly or considerably owned through the government for the purpose of undertaking activities of industrial, manufacturing, trading or allied nature. They are government owned enterprises functioning under both central and state governments. The PEs are corporate bodies, set up either under specific acts of Parliament or under Companies Act.

The PEs since they are recognized with public funds, are accountable to the public i.e. through the parliament. Autonomy in simple conditions means freedom to take decisions and function accordingly while accountability refers to rendering of accounts to some higher authority. The financial autonomy given to PEs means empowering them to take decisions on their own in the areas of investment management, financing of investments and monitoring the financial performance of respective enterprises based on sound business principles and the wisdom of the financial administrators. Insofar as investments are concerned, other things remaining the same, PEs should have - freedom in identifying the projects, preparing the detailed feasibility project reports, appraising the projects, creation investment choices, and implementing and monitoring them. They should also be free to decide the optimal stage of investments in the several items of inventory book debts and floating stock of cash. Through the same principle they should be free to peg the stage of current liabilities to any proportion of the current assets. The financial decisions in the normal run may be made through these enterprises as guided through the cost of capital. They should possess the freedom to choose in the middle of the several debt-equity propositions. They should be at liberty to select bankers, financial institutions and the channels of money and capital markets for financing their working fund necessities. Subject to the social constraints imposed on them through the government, these enterprises should be vested with the autonomy to develop their own costing and pricing systems, norms of profitability -and monitoring mechanism to ensure the desired financial status alike any business firm in the private sector.

Prof. V. V. Ramanadham in his treatise entitled “The Control of PEs in India” discusses the concept of financial accountability. Primarily it implies the accountability of PEs to parliament in financial matters. So expressed, it is part of the general problem of amenability of PEs to parliamentary control and calls for a compromise flanked by the democratic rights of parliament and the autonomy of the enterprises. The other characteristic of financial accountability is that the maximum good results ought to be secured from the PEs. So expressed, it borders on the concept of efficiency in financial conditions. The maximization is not tantamount to an insistence on the highest possible profit from every public enterprise. The concept suggests that, subject to any set criterion of profit and social benefit, the enterprise ought to record the best possible results.

TIERS OF FINANCIAL AUTONOMY AND

ACCOUNTABILITY IN PUBLIC ENTERPRISES

Financial autonomy is a phenomenon external to the organisation. In other words, it flows from the environment governing the functioning of PEs. Therefore there are six tiers of financial autonomy. These contain the parliament, the government, the Comptroller and Auditor General (CAG) of India, the Courts of Law i.e. the Supreme Court of India and the High Court, the mass media and the citizen. All these six institutions can have an explicit policy about the financial autonomy they may like to give to PEs in order to enable them to operate efficiently and effectively. As the enterprises under discussion are both ‘public’ and ‘enterprise’, these institutions cannot be over jealous in controlling each and every characteristic of financial business of PEs. The respect for the corporate status of these enterprises will have to be maintained through these institutions. While saying so we do not deny the need for exercising checks and balances on the financial decision creation in these enterprises. The main point is that these institutions should be selective in exercising the financial controls on PEs. PEs may enjoy autonomy in the day-to-day financial decision creation which in its ambit may contain matters such as normal purchases, cost allocations, evolving appropriate price structures, selection of appropriate sources and mix of finance, installation and operation of the financial information systems, and preparation and finalization of accounts, etc. On the other hand, the six institutions may though intervene in the policy characteristics of the financial decision creation. For instance, if the parliament so desires, it may discuss the financial performance, financial position, pricing, financial characteristics of foreign collaborations and the position of internal financing in PEs, etc. The government may reserve the right to approve the appointments of executives drawing salaries above sure stages and issue directives to PEs to give sure services at scrupulous prices, even if they are not economical. The CAG can provide directions to PEs to follow a specific format for the presentation of their accounts and disclosure of the financial information. The several courts of law may direct PEs to alter their financial decisions if the fundamental rights of the citizens are affected. The mass media and the citizens may criticize sure financial decisions through PEs and as a result the PEs may have to reconsider the matter. Such decisions may contain matters relating to pricing, and selection of suppliers of plant and materials which may attract public resentment. At times public enquiry can be accepted out on sure decisions taken through the management of P.E.'s. For instance in 1970, on the recommendations made through the Committee of Public Undertakings, a one man commission was set up to enquire into award of contract for laying some pipelines to an American firm through the Indian Oil Corporation.

The financial accountability of P.E.'s pertain to:

- Major Accounting Decisions: These contain: an augment in depreciation, changes in tender procedures, stores valuation and replacements.
- Matters of Internal Organisation: These contain internal audit, procedures for ordering materials, delegation of powers, watch and ward supervision over financial transactions, provisions relating to disciplinary matters etc. These are examples of matters which may be left to be properly evolved within the enterprise itself.
- Broad Financial Policies: These are fundamental characteristics of financial accountability. They require plans flanked by those evolved through the board and the socioeconomic aims set through the parliament. These may contain matters pertaining to self-financing, outlines of capital expansion programmes and the rates of dividend, repatriation of foreign funds or consultancy fees and so on.

PEs may owe an accountability to several institutions in respect of financial results, productivity and growth. The memorandum of understanding (MOU) is emerging as an significant instrumentality whereby PEs are required to spell out their objectives and the targets they are expected to achieve throughout a given financial year.

THE METHODS OF ENSURING FINANCIAL AUTONOMY AND ACCOUNTABILITY IN PUBLIC ENTERPRISES

To ensure financial autonomy, both external and internal methods have been resorted to. Externally the government spells out the financial freedom of the PEs in regard to many characteristics in their articles of association. The limits for investment, commercial borrowings, working capital borrowings, salaries offered to employees and powers of recruitment, etc., are specified in the articles of association of PEs. The provisions concerning business budgeting, costing and pricing etc. are also contained therein. The government designates the extent of autonomy to PEs in respect of pricing, investment and profitability, in the MOU. In the articles of association as well as the enabling acts under which public corporations have been set up the government exercises self-restraint on itself not to interfere in the day to day working of PEs including matters pertaining to financial functioning. Internally PEs ensure autonomy at dissimilar stages of functioning through enforcing delegation and decentralization of financial powers. In several a PE, there is a healthy tradition to hold group meetings which are also recognized as communication meetings. In these meetings the departmental heads are the invitees. The workers' representatives are also invited. The troubles are discussed and decisions are taken then and there. These meetings deal with the decisions concerning procurement, plant acquisition, investment of funds and acceptance of tender. This instrument gives a great deal of financial autonomy to the executives and work force.

The methods of ensuring financial accountability may be divided broadly into two categories: organizational methods and the external methods. The former may take the shape of arrangements which may enable a PE to provide a good financial account of itself. The external means may be a sequel to the autonomous organisation of a PE, created for ensuring that the managers, to whom it does not belong, behave responsibly vis-à-vis the parliament. The organizational means of financial accountability are as follows:

- Clear financial procedures.
- Efficient internal audit.
- Commercial audit through private auditors.
- Proper internal organisation of the enterprise, based on optimal criteria and decentralization.
- Appointment of a Financial Advisor of the enterprise through the government or under governmental approval.
- Governmental control is exercised through the Board of Directors of the PE. The Chief Executives and full-time Directors of the PEs are appointed through the government. In mainly of the enterprises government's representatives on the boards in the form of nominee directors are present. They are from the concerned Administrative Ministry and Ministry of Finance serving in an ex-officio capability on the board.
- Reservation of sure financial matters for government approval, under the Articles of Association or under the Act governing a public enterprise.
- Audit of PEs through the Comptroller and Auditor General is another means of financial accountability. In PEs there is a system of double audit. The accounts
- of PEs are first audited through the statutory auditors of the enterprise. After this is passed through the Board of Directors of the enterprise,

then the supplementary audit is mannered through the office of the C & AG.

STATUS OF FINANCIAL AUTONOMY AND ACCOUNTABILITY IN PUBLIC ENTERPRISES

Though financial autonomy is a much talked about phenomenon, there are a number of constraints on PEs imposed through the diktats from the parliament and the administrative ministry. For instance the DVC Act creates it obligatory on the Damodar Valley Corporation to report on ten financial matters, obtain approval on fifteen financial matters and receive directions from the Minister on five financial matters. As discussed earlier, in the guise of serving the public interest, a minister can always issue a formal directive to PEs. There have been cases of frequent lunch-table directives to PEs through the government. One of the reasons as to why PEs have missed linking costs with prices can be found in the undue interference through the government in their working. The guidelines issued through the Department of Public Enterprise (then Bureau of Public Enterprises) corroborate this assertion. There are more than 200 guidelines on financial matters. These guidelines range from the rate of interest which PEs should pay on their borrowings to the dividend pay-out ratio which they necessity maintain while deciding about the retention of profits. Though these are said to be guidelines, they are in a sense virtually the orders of the government.

Parliament directly exercises control in as much as its prior approval is required for sure investments in PEs and in sure cases periodic reports are to be submitted to it. This though applies only to new services, that is, for new activities, taken up for the first time. Further, such approvals are only financial and not administrative. If the parliament is not in session, the money may, in case of emergency be provided out of the contingency fund and the sanction of parliament is obtained at a later date.

The systems and procedures intended to ensure the financial accountability in PEs are very detailed and elaborate. The parliament debates the financial issues relating to PEs at the time of the budget discussions and the question hour. Further, to look into the financial performance of PEs and to check upon their commercial and business prudence, the Committee on Public Undertakings (COPU) a standing committee on PEs set up through the parliament, also helps PEs on a continuing basis to develop a proper perspective in relation to the financial matters of these enterprises. The COPU has, submitted to the parliament about 600 reports. It has also accepted out a number of horizontal studies. Some of these studies have been on financial characteristics the prominent of which contain “Financial Management in

PEs”, “Role and Achievements of PEs”, “Inventory Management in PEs”, “Project Management in PEs”, and “Galloping Expenditure on foreign travels in PEs” etc. Government controls on PEs create the financial accountability a very painful task. The reports and returns submitted on financial characteristics are monthly, quarterly and annual in nature. If these enterprises incur losses, then they have to get even their revenue budget approved through the administrative ministry. The CAG carries out not only financial but also efficiency and propriety audits for these enterprises. The annual reports place these enterprises in a disadvantageous position vis-à-vis their counterparts in the private sector on account of time overruns and poor quality of financial disclosure.

TROUBLES PERTAINING TO FINANCIAL AUTONOMY AND ACCOUNTABILITY IN PUBLIC ENTERPRISES

The financial autonomy and accountability of PEs occupy an significant place in a democratic country such as ours. Though, as things stand, these are treated as two separate facets of the personality of PEs and often the perceptions of the government and PEs on the issues relating to autonomy and accountability differ. An significant problem in this context is the government’s insistence to get matters referred to it on the several financial issues and the aversion of PEs to disclose the requisite financial information to their principals i.e. the respective administrative ministries. Whereas the government continues to treat these enterprises as its extensions, the PEs do not or cannot create concerted efforts to come out of the gravitational pull of the government. The parliament, the administrative ministry, the CAG and the Courts are measured as the trustees of public funds and are prompted, so, to impose a diversity of controls on these enterprises. They do not want to take any risk with the public money, but prefer safety and security.

Prof. Ramaswamy Iyer in his book “A Grammar of Public Enterprises—Exercises in Clarification” has recognized some regularly heard complaints concerning government’s interference in public enterprise managements. The circulars issued through the Bureau of Public Enterprises at times relate to sure unimportant and even trivial matters. Excessive monitoring through the government is also another problem. Also throughout the course of the annual plan discussions, the whole investment programme of a PE comes under review and questions are raised about investment decisions which are within the corporate powers of the public enterprise. And the economy instructions which are issued from time to time through the government applies to PEs abridging their powers. There is a gap flanked by the powers that are formally possessed through PEs and those that are actually exercised through them.

SUGGESTIONS FOR ENSURING IMPROVED AUTONOMY AND ACCOUNTABILITY OF PUBLIC ENTERPRISES

A number of suggestions can be offered to ensure improved financial autonomy and accountability in PEs. To begin with, these enterprises should be commercialized. This will enable PEs to charge economic rates for the goods and services provided to their users. This will result in the generation of adequate internal possessions and consequent reduction of financial support from the government to fund their operation and expansion needs. In turn, the government control on financial matters will decline drastically. Corporatisation of these enterprises is another suggestion. This will transform the systems, structure and strategy of PEs and resolve several thorny troubles with regard to financial autonomy and accountability.

A large number of PEs have been complaining about lack of autonomy to them as they do not have adequate powers to procure the requisite amount of materials, stores and supplies etc. On the contrary, the government is of the view that the inventories in these enterprises should be rigorously controlled as there is a heavy over-investment in this component of assets in PEs. The government’s suspicion cannot be questioned as several a PE do not have materials management manual. The absence of such a manual has encouraged them to procure materials disproportionate to their needs. The CAG in his several audit reports has commented upon the non-preparation of the budget, cost, internal audit, Research and Development and capital expenditure manuals. Several PEs do not have even the budget manual. The enhanced delegation and decentralization of financial powers within PEs is a must.

In order to achieve this objective well defined structures necessity be developed. The boards of management in PEs should specify the financial powers vested in each functionary. Likewise, the several executives in PEs should be encouraged to delegate financial powers to their junior colleagues. The government, on its part should instead of putting limits on investments, expenditure, borrowings, etc, issue only suggestive guidelines. In case a PE exceeds the suggested ceiling, it may be required to report the matter to the government. The principle of management-through-exception should be followed. The government should intervene only in such cases where it is necessary to do so in the larger public interest. PEs should formulate clearly financial strategies and goals which should be both unambiguous and quantifiable. For instance, PEs could specify proposed rate of return on their capital employed, declare a specified dividend on their equity, finance their expansion programmes largely through internal generation of possessions and approach the capital market to finance the rest of their expansion needs. A clarity in financial objectives will enable PEs to acquire the necessary financial autonomy from the government. It will also lead to self-imposed controls. This will eliminate the need for the government to clamp financial controls on them.

There necessity also be a sincere application of the Management through Objectives (MBO) for attaining financial objectives. It is desirable to eliminate the multiple audits in PEs which are mostly unproductive. It has to be noted that the counterparts of PEs in the private sector are not required to undergo so several audits. The audit approach needs to undergo a change in order to yield the desired results. The auditor's necessity be made conversant with the operations and philosophy of PEs. The annual reports can serve as an significant medium to satisfy the autonomy and accountability needs. They can be a good instrument to win greater autonomy for PEs and fulfil, at the same time, the control needs of the parliament, CAG and the Courts. An analysis of the annual reports of PEs shows that they are not brought out in time. The time lag in their finalization and presentation to the parliament ranges from one year to ten years. Secondly, in several cases they are either sketchy or lack significant information relating to the trends in output, productivity, prices, profitability, comparative performance and so on. Necessary steps necessity be taken to improve the practices pertaining to the preparation and presentation of the annual reports through PEs.

Articles 12 and 14 of the Indian Constitution have been extended to PEs whereby these enterprises have been measured as State. The 'State' as defined in Article 12 of the Constitution, is to contain "the government and Parliament of India and the government and legislature of each of the states and all local or other authorities within the territory of India or under the control of the government of India". Though originally PEs were excluded from the purview of the 'State' as defined in Article 12 of the Constitution, slowly, bodies performing quasi-governmental functions, statutory corporations, government companies, have been brought within the purview of the state. The High Courts and the Supreme Court have accepted several writ petitions which have a financial impact on PEs. Some of these relate to the procurement of materials and payment of pension etc. As discussed earlier, PEs contain not only 'public' but the 'enterprise' element. Therefore to enable PEs function without any handicaps in the present competitive atmosphere, there is a need to introduce an amendment in the Indian Constitution to take PEs out of the purview of Articles 12 and 14.

FINANCIAL AUTONOMY AND

ACCOUNTABILITY OF PUBLIC ENTERPRISES: RECENT TRENDS

The PEs in India have been set up to speeded up the procedure of industrial development. It goes without saying that, they will be able to achieve efficiency, contribute towards maximum production of goods and services with minimum wastage of possessions, only if enough functional autonomy is provided. They should have freedom of decision-creation within broad guidelines or policies. A appropriate balance needs to be struck flanked by autonomy and accountability.

There has of late, been a lot of discussion about the question of autonomy and accountability of PEs, its relationship with the government. The Arjun Sengupta Committee set up through the Government of India in 1984, went into several characteristics of public enterprise management like relations flanked by government and PEs, managerial autonomy of PEs, financial powers in regard to their investments and capital budget and so on. It recommended that the government should be primarily concerned with overall strategic planning and policy rather than day-to-day functioning of PEs which should be left to the enterprises concerned. The responsibility of the government is to ensure that public money invested in the enterprises earns an appropriate rate of return and that their functioning is constant, with plan objectives including those related to employment, fair pricing, efficient use of scarce possessions etc. The Committee was of the opinion that enterprises functioning in the core sectors like power, steel coal and lignite etc. have to interact with the ministries with regard to matters like investment planning, price fixation and financial management. Their plans will have to be integrated with the national plans. But financially viable non-core public enterprises can finance their necessities, through raising funds from the public through deposits or debentures or borrowing from, the financial institutions, without being subjected to any procedure of governmental clearance.

Concerning accountability of PEs to Parliament, the Committee recommended that Parliament questions on day-to-day operation and management may be avoided. The debate on the Demands for Grants of the concerned Administrative Ministry could be used for the purpose of a debate on the performance of PEs under the control of the Ministry. The Economic Administration Reforms Commission which was set up in 1981 headed through late L.K. Jha, also went into this characteristic of autonomy and accountability of PEs. According to the Committee, in the name of public accountability numerous checks and controls are introduced at every stage which hinder executive action, concentrates decision-creation powers in the Ministry and infact dilutes the accountability of the management. The accountability concepts and, instrumentalities which have come to prevail over the years are in need of careful reconsideration with a view to ensuring that (a) they do not erode the autonomy of PEs and therefore hamper the very objectives and purposes for which they ought to be accountable and (b) that what is sought to be secured is accountability in the wider sense of answerability for the performance of tasks and the attainment of results, rather than in the narrow sense of responsibility for the correctness and propriety or individual actions or decisions or conventionality to rules and procedures.

The Committee recommended, separately from sure statutory controls which apply to both public and private sector units, they should not be subject to any other constraints on their autonomy. Also once the investment decisions of PEs have been approved and necessary funding provided for, the management should be allowed to go ahead without seeking any further clearances except those which apply to all undertakings like those relating to industrial licensing, foreign exchange releases etc. Also the number, scope and coverage of the governmental guidelines and instructions to PEs should be thoroughly reviewed and drastically reduced and only those concerned with major objectives and/or performance parameters can be retained. There is no denying the fact that the government is convinced about providing more autonomy to PEs and reducing the wide-randing financial controls on them.

The approach outlined in the budget speeches of the Finance Minister in 1991-92 and 1992-93, the observations made in the economic survey of 1991-92 and the letter on development policy sent through the Finance Minister to the World Bank President describe the several steps the government proposes to take, in this regard. The government proposes to classify PEs as competitive and non-competitive units. About 140 units at the central stage have been recognized as competitive PEs. These enterprises will be guided through the market forces in their financial matters. The government proposes to refrain from issuing guidelines or directives. The PEs may be allowed a free hand to decide their financing, pricing and costing policies. They will be at liberty to develop appropriate systems and structures to achieve the overall financial objectives. The enterprises which are non-core in nature will not receive any budgetary support. They will have to finance their needs through the internal generation of possessions and mobilization of money from capital markets. There will be a disinvestment of equity in these enterprises Financial Administration of board of directors of PEs will be reduced to 'one'. Multiple audits may be Public Enterprises eliminated or scaled down. The government is taking appropriate steps to improve the quality of financial reporting in PEs through their annual reports. The several state governments in the country are giving a top priority to streamlining the preparation of annual accounts and annual reports in the State Stage Public Enterprises.

FINANCIAL ADMINISTRATION OF PUBLIC ENTERPRISES

MEANING AND IMPORTANCE OF FINANCIAL ADMINISTRATION IN PUBLIC ENTERPRISES

Financial administration in PEs has been defined variously. According to one school of thought, financial administration in PEs means raising the funds to fulfil the financing needs. This definition limits the scope of financial administration to the methods and instruments of raising finance. It presents the conventional view of financial administration in PEs. Today, financial administration goes far beyond the task of raising finance and deciding about the mix of financial instruments. According to another view, financial administration in PEs deals with the management of cash. This definition implies that all such activities which affect the cash flow in PEs can be measured as financial administration. This is a very broad definition of financial administration as there cannot be several activities which do not influence the cash flow in PEs and as such it lacks operational validity. Some experts conceptualize financial administration in PEs, as that group of activities which deal with raising of finance, its allocation in the middle of dissimilar purposes and monitoring their financial performance. This definition possesses conceptual clarity and also combines operational validity.

As noted earlier, financial administration is one of the major functions in PEs. It has to regularly interface with other business functions. A healthy interaction flanked by finance and no finance administrators is a pre-requisite for a successful functioning of PEs. In reality, though this interaction hardly exists. Despite the usefulness of financial input in operating decisions, the operating administrators refrain from interacting with the financial administrators. There is a popular belief that finance function is disliked through the several functionaries in PEs. Though, a revise on the audit practices accepted out through the Institute of Public Enterprise reveals that about 85 per cent of functionaries at all stages and in the dissimilar age groups preferred the continuation of audit. The financial administrators have brought this significant function to disrepute because they try to control the performance of their counterparts in the operating departments more in conditions of means and procedures than ends. In conditions of the help provided to the non-finance executives, the financial administrators are found mostly indifferent. The ideal situation is one of providing active help. The exercise of the preparation and execution of budgets can be cited as a case in point. The budget should not be reduced to a game of numbers through financial administrators. It should be transformed into an exercise that may enlist the support and cooperation of all functionaries in PEs. On the part of the non-finance functionaries, they will do well to inculcate a positive approach to finance function and overcome the inertia of consulting the financial administrators as and when required from time to time.

FUNCTIONS OF FINANCIAL ADMINISTRATION IN PUBLIC ENTERPRISES

The financial policy of PEs is intended to achieve an optimal output at the lowest cost. It further aims to arrange to give the financial inputs in a manner that may contribute to smooth functioning of PEs. In the effort to achieve this end, financial administrators have to execute the following functions:

Acquisition of Long-Term Sources of Funds

The financial administrator has a dual responsibility with regard to the acquisition of funds. He/She advises on the choice of appropriate sources of funds and then takes steps to procure the funds from the chosen sources. The funds employed in the enterprise may be classified into two groups' long-term funds and short-term funds. The long-term sources of funds are further classified as debt and equity. Successful enterprises seek debt in preference to equity for reasons of cost, convenience and control. Debt is a less expensive source, since tax savings are possible on interest paid. Servicing equity, on the other hand, entails payment of tax. The overall cost of capital, so, varies in an inverse proportion to the debt component in the capital structure of the enterprise. Secondly, debt is relatively more convenient to obtain when needed and to redeem when not required. Debt does not also result in any dilution of control over the affairs of; the enterprises since lenders do not acquire any voting rights. Lastly, low-cost debt gives a leverage which helps in achieving a higher rate of return on equity.

There are, though, definite limits to debt financing. Debt involves financial risks which need to be commensurate with the business risks. The business risks arise 'from likely changes in demand for the product, emergence of competition or imposition of controls over prices, imports, exports etc. The financial risk grows in proportion to the debt component in the capital structure. It is essential to set definite limits to debt financing.

Limits to debts are fixed keeping in mind three interrelated standards, namely, industrial norms, debt servicing capability and the cash adequacy throughout recession.

- Each industry adheres to sure norms of capitalization on the basis of its asset structure and magnitude as well as volatility of its earnings in the long run. Industries whose earnings are subject to high risks of obsolescence prefer self-financing and go in for a large equity base which can withstand the shocks.

- The second factor, namely, the debt servicing capability is taken as a fraction of the annual cash accruals. Conservative bankers insist on debt service coverage ranging from 200 to 300 per cent.
- The cash adequacy standard is a variant of debt service capability standard and is based on cash flows expected throughout the recession period. The objective is
- to ensure the required capability to service the debt even under the worst circumstances. The three norms together guide the management

  in deciding the limits upto which it can seek funds in the form of debt.

It may be relevant to have a closer look at the equity-debt proportion in the capital structure of the central PEs. There are very few instances where the debt is more than the equity and even in these cases, the excess is due to the erosion of net worth because of accumulated deficits. The overall position is more or less in conformity with the age-old policy of the government to maintain a 1:1 ratio for debt and equity.

Acquisition of Short-Term Sources

The current assets held through one enterprise are financed mainly from short-term sources. Though, the long-term sources are supposed to give the margin money and also take care of investments in the core current assets. Bank borrowings in the form of overdrafts or cash credit, suppliers' credit and other current liabilities constitute the major sources of short-term finance accessible to an enterprise. Bank borrowings have become so expensive now-a-days that they are exerting a restraining influence on the enterprises. They are trying to manage their current assets more efficiently and are at the same time, looking for alternative and less expensive sources of short-term finance.

The government follows the policy of asking PEs to obtain their credit necessities from the nationalised banks. In those cases where the enterprises are short of margin money, the government extends a guarantee to cover the deficit. When they find it impossible to obtain their total necessities of working capital from the banks, the government gives, short-term loans for a specific period.

Investments in Long-Term Assets

The enterprises employ their capital partly in fixed assets and partly in current assets. The financial administrators have to ensure that funds at the disposal of the enterprise are judiciously employed and that the proposals for further investments are economically viable. The investments in fixed assets involve substantial long-term commitments in conditions of finance as well as technology. The proposal for each investment is to be, so, subjected to a cost benefit analysis.

A professional analyst creates use of a number of techniques like average rate of return, internal rate of return, pay back period, net present value (NPV) etc., for carrying out the cost benefit analysis. All these techniques help financial administrators in choosing the best project.

Short-Term Investments

Major investment decisions may be subject to external pressures on the enterprise. But the decisions on current asset-holdings fall well within the scope of internal management. Investments in inventory can be regulated to ensure that excess stocks and stock-outs are avoided. Likewise, efficient management of trade credit helps in keeping the investments in sundry debtors to the absolute minimum. Better management of cash offers scope for reducing the interest burden on the enterprise. The techniques of ABC analysis, economic order quantity, re-ordering stage, value analysis, etc., help managing the current assets more efficiently.

Planning Systems

The planning procedure in the enterprise comprises strategic planning, long-term corporate planning and annual performance budgeting. It also covers economic and financial analysis needed for short-term decisions. Strategic planning refers to planning of major strategies concerning expansion, diversification, taking up manufacture of new products, entering new markets, etc. The financial administrator plays a crucial role in marshalling the relevant costs and benefits and in advising the management on the long-term financial implications in conditions of outlays and cash flows expected. He/She works closely with the team engaged in the strategic planning procedure. The criteria for investment decisions mentioned earlier are integral to the procedure of strategic planning.

Long Range Corporate Planning is the procedure of developing a time bound plan for achieving the objectives of an enterprise over a period of five or more years. It takes into account all the on-going activities as well as the new projects being taken up and prepares an integrated total plan for the enterprise as a whole. Here again the financial administrator plays a major role in assimilating the data, appraising the alternatives and developing master budgets and financial forecasts for covering the plan period.

The performance budget is an extension of the corporate plan. It is prepared in greater detail and sets physical and financial targets for each responsibility centre and builds the efficiency norms into them. The budget therefore serves as an instrument of planning and control. Since profitability is not the guiding index of efficient performance, what is needed is a system for review and target setting for each segment of the enterprise. The Management through Objectives (MBO) may also give a framework for formulating and implementing the performance budget. These budgets enable decentralization of authority and centralization of control. Budgets also help management-through-exception.

Operating Decisions

There are very few decisions at the enterprise stage which do not affect its funds. It is, so, logical for the financial administrators to have a say in those decisions. Leaving aside the investment decisions mentioned earlier the operating decisions cover a wide range of troubles such as capability utilization, pricing, overtime working, shift-working, product-mix, credit policy and incentives.

Control Systems

Budgetary control and standard costing systems give the basis for monitoring enterprise performance at all stages. They introduce a participative element in the target-setting exercise. The financial administrator is expected to develop an integrated system which incorporates financial accounting as well as management accounting systems. The system has to be so intended as to generate data for compiling periodical reports to be sent to the administrative ministry, Finance Ministry and Planning Commission etc. It should also give information to enterprise managers at all stages about their achievements vis-à-vis plans and targets. These managers need assistance in identifying and analyzing cost variance as well as profit variance.

Internal Audit is measured to be an integral part of finance function in mainly of the PEs. It is internal appraisal and is mainly concerned with the evaluation of the effectiveness of managerial controls including systems and procedures. The external auditors rely very much on the internal audit for ensuring the credibility of vital records. The financial executive coordinates with statutory auditors in carrying out the external audit. PEs are audited directly through the Comptroller and Auditor General of India (CAG) or through chartered accountants appointed through him as auditors. In the latter case, he has powers to carry out a supplementary test audit. There is an audit board which coordinates the external audit work in respect of central PEs in India.

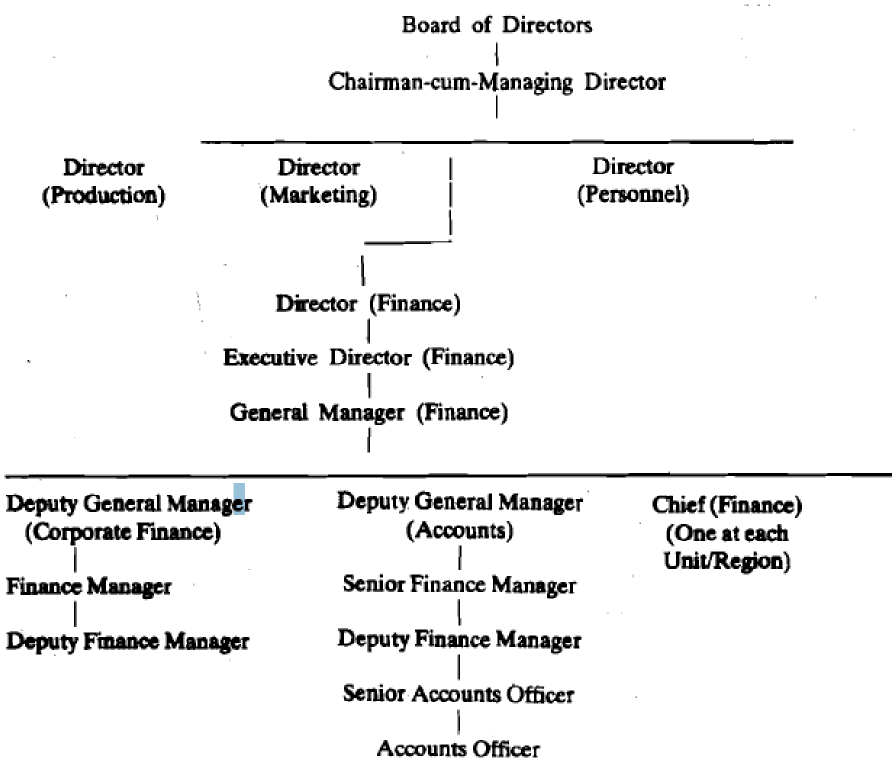
FINANCIAL OBJECTIVES FOR PUBLIC ENTERPRISES

PEs are dissimilar from private sector enterprises in conditions of their nature as well as their obligations to the nation. The private sector enterprises possess a great deal of clarity in conditions of their objectives which is essentially the maximization of their profitability. PEs are composed of two conditions, viz. ‘public’ and ‘enterprise’. Through being ‘public’ these enterprises stand accountable to the government. Their management and ownership also rests with the government on account of this feature. The term ‘enterprise’ means that PEs have to produce sure goods or render sure services at a price resulting in excess of income over expenses which should be duly reflected in the profit and loss account and balance sheet. Further, these enterprises operate in diverse sectors including manufacturing, financial, promotional and welfare activities. There are about 1100 State Stage Public Enterprises (SLPEs) run through state governments of the Indian Union and 240 central PEs. Though, these enterprises can still have uniform financial objectives which may range from the retention of the net worth to its maximization implying the fact that enterprises at the bottom of the scale will have to keep their net worth intact whereas enterprises at the other point of the scale can multiply their net worth in a business like manner. The welfare enterprises engaged ’ in serving the needs of the weaker sections of the society are not suited for profit maximization. Though, in order to maintain their present stage of operations and their likely expansion, they necessity keep their net worth intact. On the other hand, the manufacturing enterprises operating in competitive sectors can maximize their net worth based on the market leads.

FINANCIAL ORGANISATION OF PUBLIC ENTERPRISES

Organisation for finance has undergone a radical transformation in PEs with the changes in the environment governing PEs and their structures. The financial organisation has acquired sophistication and complexity with the mercerization and partial privatization of PEs.

Diagram shows a typical organisation chart of the Financial Management Division in PEs.



As the diagram shows, the Finance Division is headed normally through the Director (Finance) who holds a board stage position. He advises the Chairman-cum-Managing Director (CMD) on all matters pertaining to finance and accounts. He is responsible for formulating and coordinating the financial plans. He executes a staff function and at the same time happens to be a line authority for the executive in the finance department. He is assisted in his task through Executive Director (Finance) and General Manager (Finance). The Executive Director is assigned some specific tasks besides helping the Director (Finance) in the formulation of financial policy. These may contain responsibility for audit and preparation of budget. The General Manager (Finance) is saddled with routine affairs such as the preparation and finalization of accounts, compilation of budgets, handling of cash credit and arranging corporate finance. In mainly of the PEs, the Director (Finance) is recruited through the Public Enterprise Selection Board. The earlier convention of deputing the officer from the Finance Ministry or the Indian Audit and Accounts Department has been abolished through the government. Diagram 1 shows that in case an enterprise is a multi-unit/multi-product concern, the financial organisations give for a functionary (normally of the stage of General Manager) to head this function at the several locations or product groups. '

INVESTMENT MANAGEMENT IN PUBLIC ENTERPRISES

Investment proposals for establishment of new units or expansion of existing units emanate either from ministries/departments of the government or from the enterprises desiring expansion and growth. The broad nature of investment is determined through the priorities indicated in the National Plan. Individual investment proposals are required to be within the overall programmes outlined in the plan document. The government exercises a measure of control over the size and pattern of investments in the PEs through reserving to itself the power to approve capital outlay exceeding sure financial limits. The government also exercises control over such investments through the mechanism of scrutiny and approval of the annual capital budgets of the concerned enterprises.

The investment proposals are examined through several agencies of the government including the Projects Appraisal Division of the Planning Commission and the Plan Finance Division from financial, technical, economic and management viability angles. Their relevance to the overall plan objectives, availability of possessions, social cost-benefit, etc., are also assessed. All investment proposals costing Rs. 20 crore and above require approval of the government at the highest stage after these are cleared through the Public Investment Board. The Public Investment Board is constituted with the Secretary (Expenditure) in the Ministry of Finance as Chairman. Its other members contain Secretary, Planning Commission, Secretary, Department of Economic Affairs, Secretary, Industrial Development, Secretary, Department of Public Enterprises, Secretary to the Prime Minister and Secretary of the Administrative Ministry which has made the investment proposal to the Board. As per the delegation of financial powers effective from 8th June 1988, the powers of the ministry/departments with integrated finance system, for sanctioning projects/schemes, was enhanced upto Rs. 20 crore but this power can be exercised after following usual Expenditure Finance Committee (EFC)'procedure and after obtaining the comments of the Planning Commission and other appraising agencies. Projects costing Rs. 20 crore and above continue to be measured through the Public Investment Board, and

Cabinet Approval is also obtained where expenditure is Rs. 20 crore or more. The powers of the Board of Directors of PEs to sanction capital expenditure were also enhanced in August 1986. As per the revised delegations, the powers of the Board of Directors are as indicated below:

Public Enterprises with Gross Blocks of:	Power to sanction capital expenditure without prior approval of Government
Less than Rs. 100 crore	Rs. 5 crore
Between Rs. 100 crore and Rs. 200 crore	Rs. 10 crore
Above Rs. 200 crore	Rs. 20 crore

In addition to the above delegation, Government (vide O.M. dated 7.11.88 and 29.8.1990) has further delegated enhanced powers to Board of Directors of Memorandum of Understanding (MOU) signing companies to incur capital expenditure. As per the revised delegation, it has been decided that in respect of companies signing MOUs and having gross block of over Rs. 200 crore, the power to incur expenditure on additions, modifications and new investments will be raised from the existing limit of Rs. 20 crore to Rs. 50 crore without prior approval of the government. Further, the power to incur expenditure on replacement renewal of assets from the present limit of Rs. 50 crore to Rs. 100 crore is provided subject to sure circumstances.

PUBLIC ENTERPRISES-SOURCES OF FINANCE

There are several sources of financing PEs. These mainly constitute equity and grants received from the government, public participation in equity, borrowings from the open market in the form of public deposits and issue of bonds, foreign investment and cash credit advances. The government is the main provider of funds to PEs. It finances PEs through equity grants and borrowings. The borrowings are provided at a rate of interest of 14-16 per cent per annum for long-term funding. The equity is provided for long-term funding at no cost. Therefore, the equity represents the perpetual interest-free capital. To check the misuse of cost-free funds, the government has initiated a scheme of disinvestment of equity in PEs from 1991-92 in which year Rs. 3,000 crore was received from the sale of PE shares through mutual funds. The government’s total equity in the Central PEs was of the order of Rs. 38,634 crore as on March 1,1990. The long-term loans provided through the Government to PEs amounted to Rs. 24,585 crore as on the same date. The central government provided about 68 per cent of the total financing needs to these enterprises in 1989-90. The foreign participation in conditions of equity and debt amounted to Rs. 14,221 crore as on the same date which amounted to about 14 per cent of the total financing needs in 1989-90. The equity and loans provided through the financial institutions amounted to Rs. 5,213 crore and constituted about 5 per cent of the total financing needs as on March 31,1990. The private participation through way of bonds, equity and public deposits amounted to Rs. 60,496 crore which represented roughly 16 per cent of the total financing needs as on March 31, 1990.

The working capital requirement of PEs are usually met through cash credits and advances arranged with the State Bank of India and nationalised banks. The total amount of outstanding cash credit drawn through the central PEs stood at Rs. 13,973 crore as on March 31, 1990. In special cases nonplan loans also are arranged through the central government to some enterprises to meet their working capital necessities. As on 31 March 1990 an amount of Rs. 14.40 crore was due from these enterprises under this head. Despite the recommendations made through many expert committees/commissions such as the Krishna Menon Committee (1959), Administrative Reforms Commission (1967) and Committee on Public Undertakings (1971), these enterprises did allow public participation in their equity. The internal financing through generation of internal funds through way of depreciation, write-offs and retained profits constitute another significant source of financing PEs. Internal financing is a cost free source of finance. Flanked by 1985-86 and 1989-90 internal possessions generated through these enterprises stood at Rs. 37,677 crore. Not only the volume of internal generation of possessions increased flanked by 1985-86 and 1989-90 from Rs. 5,067 crore to Rs. 10,779 crore, respectively, but the number of PEs generating internal possessions also increased from 126 to 150 throughout the same period. The generation of internal possessions reduces the dependence of PEs on the government and thereby acts as an significant measure of autonomy.

REVIEW QUESTIONS

- What do you understand through financial autonomy of PE?
- Point out the areas of financial accountability of PEs.
- Discuss the methods of ensuring financial accountability of PEs.
- Look at troubles pertaining to financial autonomy and accountability in PEs.
- Discuss the functions of financial administration in PEs.
- Explain the investment management and financing of PEs;

CHAPTER 9

LOCAL FINANCE

STRUCTURE

- Learning objectives
- Financial administration of rural governments
- Financial administration of urban governments
- Review questions
-

LEARNING OBJECTIVES

After reading this unit, you should be able to:

- Describe the machinery concerned with financial administration in rural governments.
- Discuss the concept of rural development and the principles of rural local finance.
- Explain the several characteristics of rural fiscal management.
- Explain the major divisions and the machinery concerned with financial administration.
- Discuss the ecology and principles of urban local finance.

FINANCIAL ADMINISTRATION OF RURAL GOVERNMENTS

CONCEPT OF RURAL DEVELOPMENT

The term 'rural' means an area characterized through non-urban style of living, greater inter-dependence in the middle of people, more deeply rooted community life and a slow moving, rhythm of life based on faith and conviction in religious ethics and themes. Occupationally it is based on crop farming, tree crops and related activities like plantation, agriculture, modern dairying, fish farming, sheep rearing etc. The growth and development of urban areas has been at the expense of rural areas and with the emergence of city centers, the rural areas were neglected. This was much more true so far as the rural population in developing countries was concerned. When the umbrella of colonial regime was lifted from the third world nations, mainly of the planners and administrators of these newly independent nations, got concerned with the development of the rural areas of their nations. This concern was largely because a majority of the population was living in rural areas under abject poverty, malnutrition and unsanitary living circumstances. Ignorance and poverty were two stumbling blocks in their development and their removal was the main objective of the independent nations. The commitment of the leaders of these nations was to bring in prosperity and improve the quality of life of the people in rural areas, constituting a big resource for them as electorates in the elections. Invariably, this commitment becomes a prime mover with them at the time of elections and its tempo gets diminished in due course of time. Some piece-meal programmes or projects on rural development are brought to the people in the rural areas and these are in several cases not in consistence with their need structure. The adhocism in the planning of these programmes and half-baked implementation strategies have raised the vital issue of what is required to be developed in these areas. This brings in the problem of conceptualizing rural development.

A comprehensive concept and method of rural development has been suggested through the World Bank. Rural development has been defined as a “strategy to improve the economic and social life of a specific group of people that is the rural poor including small and marginal farmers, tenants and the landless”. A national programme of rural development should contain a mix of activities including projects to raise agricultural 'output, make new employment, improve health and education, expand communications and improve housing. The nature and content of any rural development programme or project will reflect the political, social and economic circumstances of the scrupulous country or region ” Since Independence, rural development has been the main thrust of national development effort. The guiding principles of planning are growth, equity, social justice, self-reliance, improved efficiency and productivity. A number of development programmes from Community Development Programme to Jawahar Rozgar Yojna were started to change the scenario in the rural areas in India. These programmes have been of some help in solving the problem of migration of people to urban areas to some extent. This is apparent from the fact that the percentage of rural population to total population dropped only moderately from 82.7 per cent in 1951 to 80.09 per cent in 1971. Green Revolution of the sixties and White Revolution of the early seventies seem to have changed the gloomy outlook of a large chunk of rural population. Though, it is an irony of fate that because of the population growth and rising expectations not much of development is visible.

RURAL GOVERNMENT: EXPENDITURE PATTERN

An analysis of the expenditure pattern of Panchayati Raj Institutions shows that it is on the increase. Population growth, inflation, and the involvement of these institutions with the nation-structure activities on agency basis are some of the factors responsible for rapid augment in expenditure. A look at the budget of Panchayat Samiti shows that the expenditure is divided under two heads i.e. plan and non-plan. The plan expenditure involves the expenditure for which the provision is made in the State Plan Schemes, Centrally Sponsored Schemes and Central Plan Schemes. The Panchayati Raj Institutions usually depend upon grants, borrowings, subsidies etc., to finance this kind of expenditure. The non-plan expenditure comprises salaries, travel expenses, office expenses, medical reimbursement, contingency etc. The major heads of expenditure shown in the budget are: health and rural sanitation, education, communications, animal husbandry, family welfare, salaries of the staff, audit fee, law. charges, repayment of loans etc. Table given below shows the expenditure on dissimilar heads, incurred through the Panchayat Samiti in Chandigarh throughout the year 1987-88.

Expenditure Pattern of Panchayat Samiti in Chandigarh

Head of Account	1987-88 (In Rupees)
Establishment	2,35,000
Health and Rural Sanitation	22,00,000
Schemes purely executed from Panchayat Samiti Fund—Family Planning, Family Welfare	55,000
Education	15,00,000
Social Education	20,000
Grants-in-aid to Panchayats for development work	20,000
Law charges	15,000
Fairs and shows	15,000
House Building Advance to Staff	20,000
Repayment of loans	37,500
Refund of Interest to Bank	1,667

RURAL FISCAL MANAGEMENT

Since governments spend public money for public purposes, economical and efficient use of public money is a very significant task of fiscal management. It is suggested that a government which has worked out a satisfactory system of fiscal management has gone a long way towards putting the administration of its affairs upon an efficient basis. The fiscal management involves a continuous chain of operations such as budget preparation and its approval through competent authority, assessment and collection of revenues, custody and disbursement of funds, maintenance of proper accounts and their audit.

Budget preparation and its approval

In Panchayati Raj Institutions, budgeting is one of the major processes through which the use of the public possessions is planned and controlled. The budget plays a very significant role in the social and economic life of a community. In India, the long-term objectives of the Five Year Plans of the Government influence the revenue and expenditure pattern of Panchayati Raj Institutions as shown in the annual budget. Every year, the Gram Panchayat prepares its budget towards the year-end. The Sarpanch and the Panchayat

Secretary in consultation with Panchayat members attempt to frame the budget which is placed before the Gram Sabha at its Sawani meeting for consideration and suggestions. In case, a Gram Panchayat fails to prepare the budget, the respective Panchayat Samiti prepares the budget and places it before a specially convened meeting of the Gram Sabha concerned for necessary action. It may be clearly noted that Gram Sabha has only to consider the budgetary proposals placed before it. It does not have the power to formally pass them. Usually it is passed in the form of a resolution and sent to the respective Panchayat Samiti for its sanction. Therefore, it can be said that if Gram Panchayat defaults, the respective Panchayat samiti is the formal authority to frame and finalize its own budget.

The budget estimates of receipts and expenditure of Panchayat Samiti are drawn up through the Executive Officer (B.D.P.O.). These estimates contain the (a) actual of the previous year, (b) budget estimates for the current year, (c) revised estimates of the current year, and (d) budget estimates of the after that year. The Executive Officer endeavors to prepare the estimates as accurate and realistic as possible and keeps in view amounts which are expected to be received through the Panchayat Samiti from the Government through way of grants-in-aid for Community Development Programme and schemes transferred through other departments of the State Government. After careful scrutiny of the budget estimates through the Executive Officer, it is submitted to the Standing Committee on Finance and Taxation for its secure scrutiny or any modification as it may consider fit. After the scrutiny through the Committee, the budget is again submitted to the panchayat Samiti for consideration, which may approve the budget with or without any modification. The budget so approved is sent to the Zila Parishad which may or may not suggest any alteration in the budget. In Punjab, in case of variation of opinion, the decision of the Zila Parishad is final and binding on the Panchayat Samiti. But the situation differs from state-to-state. Even in the case of Punjab, the differences are usually resolved at the political stage.

The Secretary of the Zila Parishad prepares the budget every year and places it before the Standing Committee for finance and taxation. After having measured the estimates of receipts and expenditure, the standing committee submits the budget to the Zila Parishad for approval. As soon as it is passed through the Zila Parishad, it is sent to the government so that it can be scrutinized with a view to pointing out any misuse or abuse of funds placed at the disposal of the Zila Parishad. Therefore, it is clear that the budget as passed through the Parishad is final. Separately from this, it is significant to note that the departments concerned prepare the District-wise statement of funds to be placed at the disposal of the Zila Parishads and the Panchayat Samitis and pass on the same to the State Government before the prescribed date each year. The Government communicates to each Zila Parishad the allocation of funds for schemes earmarked to the Zila Parishad as well as

Panchayat Samitis. The Zila Parishad then meets immediately and decides block-wise allocation of funds and conveys its recommendations to the government. Keeping in view the recommendations of the Zila Parishad, the government communicates to each Panchayat Samiti the allocation of funds allotted to it for the schemes to be executed through it throughout the after that financial year. On receipt of the intimation of the allocation of funds, the Panchayat Samiti prepares its budget and submits it to Zila Parishad for approval as mentioned earlier.

Assessment and collection of taxes

Assessment of taxes involves the preparation of a list of persons liable to pay the tax, and determining the amount of tax that has to be paid through them. The procedure for the assessment and collection of taxes varies from State to State. In Punjab, the Sarpanch assisted through Panchayat secretary. the Executive Officer of Panchavat Samiti or the secretary of Zila Parishad is primarily responsible to ensure that all taxes are collectively, promptly and regularly assessed and realised. He has also to see that taxes composed are brought to account and there is no leakage.

In order to collect taxes, a fresh Demand Register is prepared every year. The nature of demand, name and address of persons through whom tax is payable etc. are entered in the register. If an assess feels that an assessment of his liability to a tax is not correctly and fairly made, he is entitled to create objections within a prescribed period, usually before the assessing officer himself. If he is not satisfied with the decisions on his objections, he is usually entitled to appeal to some higher officer. The detailed. procedure in regard to arrears, refund of taxes, receipt of payment through cheque etc. is laid down in rules framed through the State Government.

Custody and disbursement of funds

All taxes realised through the Panchayati Raj officials are credited to the account of the fund of Gram Panchayat, Panchayat Samiti and Zila Parishad. The drawing and disbursing officer while incurring or authorizing expenditure out of the fund shall observe the cannons of financial propriety which are given below:

- Every officer incurring or authorizing expenditure on behalf of the Panchayat Samiti or Zila Parishad should be guided through cannons of financial propriety. He is responsible for enforcing financial order of strict economy at every step.
- Every officer is expected to exercise the same vigilance in respect of expenditure incurred out of the fund as a person of ordinary prudence would exercise in respect of expenditure of his own money.

- The expenditure should not prima facie be more than the occasion demands.
- No authority should exercise its power of sanctioning expenditure to pass an order which will be directly or indirectly to its own advantage.
- Money out of the fund should not be utilized for the benefit of a scrupulous person or section of the community unless:
    - the amount of expenditure involved is insignificant, or
    - a claim for the amount could be enforced in a court of law, or
    - the expenditure is in pursuance of a recognized policy or custom.
- The amount of allowances granted to meet expenditure of a scrupulous kind should be so regulated that the allowances are not on the whole a source of profit to the recipients. Money indisputably payable should not, as far as possible, be left unpaid.

Stores

The term 'Stores' comprises all articles and materials purchased or otherwise required for the use of or in the service of Panchayat Samiti or Zila Parishad, whether these are Consumable like articles of stationery etc., or non-consumable like instruments, furniture etc. Detailed rules have been framed for the procurement, custody and issue of stores.

Accounts and audit

After the budget has been approved through each unit of Panchayat Raj, the procedure of public expenditure and revenue collection starts. Since a lot of public money is spent through the Panchayati Raj officials, maintenance of proper accounts and audit of expenditure assume great importance. It is only through systematic accounts supported through vouchers and receipts that the legality and honesty of the transactions can be determined. In Gram Panchayats, Sarpanch helped through Panchayat secretary is responsible for the maintenance of accounts. Likewise, the accounts of the Panchayat Samiti are maintained through the Executive officer and that of the Zila Parishad through the Secretary. All the accounts of receipts and expenditure have to be kept in a manner and form determined through the State Government from time to time.

The Secretary to Government, Finance Department and Examiner Local Fund Accounts are responsible for the examination and audit of the accounts of receipts and expenditure of Gram Panchayats, Panchayat Samitis and Zila Parishads who in turn create appropriate arrangements to enable the auditor for conducting audit. The purpose of the audit is to ensure that the money has been spent with honesty, efficiency and economy. Further it has to see that the money has been spent according to the rules, regulations and sanction of the concerned authority. It has also to point out whether budgetary grants have been exceeded or whether there was any case of misappropriation or waste of public funds. The Examiner, Local Fund Accounts prepares an audit report on the annual accounts of Panchayat Samitis and Zila Parishads. This report brings out the true financial picture as on the last working day of the financial year to which it pertains. The audit report beside with the annual accounts is placed before the Panchayat Samiti and Zila Parishad for necessary action. Further, the annual accounts beside with the audit report of Panchayat Samitis is examined and discussed through the Public Accounts Committee of Zila Parishad. Likewise, the audit report of the accounts of Zila Parishad is also examined and discussed through the Public Accounts Committee separately constituted at the divisional stage. The recommendations of these committees are of binding nature. The Government has the power to determine a system of pre-audit or test check in consultation with the Examiner, Local Fund Accounts in respect of the accounts of Panchayat Samitis or Zila Parishads. The decision of the government in this respect is final.

STATE CONTROL AND SUPERVISION

Panchayati Raj Institutions like urban local bodies are non-sovereign entities. Though authority and responsibility have been transferred to these institutions, under democratic decentralization, they do not enjoy absolute autonomy to manage their own affairs. They function under varied forms and degrees of control exercised through the respective state governments. Had they not been under any control, they would not have been local authorities, but sovereign states. The main purpose of the government control is to assist, guide and direct these institutions so that they do not create mistakes. This is what Mehta Committee observed. “It necessity not be cramped through too much control through the government or government agencies. It necessity have the power to create mistakes and to learn through creation mistakes, but it necessity also receive guidance which will help it to avoid creation mistakes” State Legislature exercises legislative control government departments, exercise administrative control, and the courts, exercise judicial control.

Financial control is one of the mainly effective instruments of government control over Panchayati Raj Institutions. This kind of control is more or less similar in approximately all the states and is exercised in matters relating to taxes, budget, grants-in-aid, loans, accounts and audit. The taxation powers of the Panchayati Raj Institutions are strictly controlled through the government. Every resolution of each unit of Panchayati Raj to augment or decrease the rate or even to abolish an existing tax needs the approval of State Government.

In Punjab, the government is empowered to permit Panchayat Samitis to impose tax on any subject of the state list. The government may even suspend or abolish a tax which it considers to be unfair in its incidence or injurious to public interest.

In all the states, detailed accounting procedures have been laid down in matters pertaining to itemization of receipts and expenditure, custody and disbursement of funds, stores, periodical scrutiny of accounts through the appropriate authorities, and so on. Besides, the accounts are also subject to government audit which is an significant instrument through which control and supervision is exercised, deficiencies located and loopholes plugged to ensure financial discipline.

The State Government has a financial stake in Panchayati Raj Institutions. It gives financial assistance in the form of grants to these institutions. It is. so, but natural that the provider or guarantor of funds has a responsibility to ensure that they are not misused or diverted to unapproved schemes. Therefore one who pays the piper calls the tune. Besides, every proposal to raise loan requires approval through the state government. Before government gives the green signal to borrow, it examines the scheme in detail, reviews the whole financial position of the unit of Panchayati Raj concerned, fixes the period of repayment, determines the mode of borrowing etc. Budgets are to be prepared through the Panchayati Raj Institutions in the manner and form as prescribed through the state government, which may also frame rules in regard to the time schedule for the submission of budget to higher authorities. In some states, it is the superior tier of the Panchayati Raj that has the power to sanction the budget. For instance, the budget of the Gram Panchayat is approved through the Panchayat Samiti and Samiti's budget through the Zila Parishad. The system of supervision within the three-tier structure is an significant characteristic of democratic decentralization envisaged through the Balwantrai Mehta Committee which also recommended that village panchayats should be supervised through the Panchayat Samitis, the Samitis through the Zila Parishad and the Zila Parishads through the State Government. All this was to be in addition to the powers of the Deputy Commissioner and other State officials who exercise similar powers of supervision. Last but not the least, the state government is empowered to either supersede or dissolve the Panchayati Raj Institutions on the grounds of persistent maladministration, corruption, misappropriation of funds etc. It is the ultimate weapon in the armory of the state government to put the Panchayati Raj on rails.

GAP FLANKED BY RURAL SERVICES AND POSSESSIONS

A review of the working of Panchayati Raj shows that it has not come up to the expectations of the people. There are several troubles that have made Panchayati Raj Institutions ineffective in accomplishing their vital purpose. It is usually the view that part of the inability of these institutions in performing their functions satisfactorily lay in their weak financial possessions. The troubles of Panchayati Raj finance are of varied character. In the first place, it has been noticed that in spite of wide taxation powers, Panchayati Raj Institutions have not utilized them fully. The Asoka Mehta Committee's findings reveal that these institutions have rarely utilized their taxation powers. It observes: "In spite of all the exhortations on the need to raise their own possessions through way of taxation, there is a general resistance through the Panchayati Raj Institutions to imposing taxes. This reluctance is visible not only in the case of Panchayats which are in face-to-face get in touch with the people but also in the case of the Zila Parishads even in such states as Maharashtra where they are performing a diversity of developmental functions and need additional possessions". This unwillingness to mobilize the possessions is due to the unpopularity of the measure and the representatives fear of their being unseated at the after that election. There is no exaggeration that the minimum that an elective body can do to alienate the sympathies of its constituents and to ensure the defeat of its sitting members at the after that polls is to provide the people heavier doses of taxation. Several committees which have examined, from time to time, the problem of local finance, have drawn pointed attention to this factor. Hence, the Asoka Mehta Committee recommended that some of the local taxes should be made compulsory. It observed, "The thesis 'no taxation, only representation' should be discouraged. Representation involves inescapable responsibility of raising possessions for development and welfare work". Further, the borrowing facilities accessible to Panchayati Raj units are too restrictive. The Local Authorities Loans Act, 1914 under which these units can raise loans is not much suited to the needs of the modern times and requires a complete overhaul. It has been suggested that the scope of the purposes for which loans can be raised, the period and other circumstances of repayment should be liberalized keeping in view the rural poverty. The establishment of a new financing body like a Panchayati Raj Finance Corporation in the states of Uttar Pradesh and Bihar to give loans to Panchayati Raj Institutions to enable them to take up dissimilar kinds of remunerative enterprises has not been favored through Asoka Mehta Committee. The Committee was of the opinion that it is not likely to add to the total availability of the credit.

Separately from this, the present system of grants-in-aid suffers from sure shortcomings. The grants are unrelated to the needs, these are irregular, uncertain and their release is sometimes based on political thoughts. To fill up the gap flanked by revenue and expenditure, the grants should be made accessible to these institutions on time and their release on political thoughts should be avoided.

Though there is a provision for government audit of Panchayati Raj

Institutions, yet there are serious gaps in actual practice. It has been noticed that the accounts, especially, of Village Panchayats, have remained unaudited for years at times. Panchayati Raj units have not cared to consider or remove the audit objections within the stipulated period. Hence, audit should be mannered regularly and the impression of its dispensibility should not be allowed to gain ground. The persons found guilty of misuse of funds should be given exemplary punishment and shown no leniency. In order to ensure that weaker sections of the society derive maximum benefits from the several plans, the Asoka Mehta Committee suggested that there should be an independent authority to carry out 'Social Audit' of the funds and programmes earmarked for the Scheduled Castes and Scheduled Tribes and to ensure that projects intended for them are implemented in a way that the desired impact is not diluted. Improper sharing of sources of income flanked by the state and rural local bodies, limited financial autonomy, undeveloped trading enterprises, increased population pressure and functions etc., are some of the reasons for inadequate financial possessions of Panchayati Raj Institutions. To improve the financial circumstances of local bodies, creation of a separate tax-zone was strongly recommended through the Local Finance Enquiry Committee (1949-51) and the Taxation Enquiry Commission (1953-54).

There is nothing new in this arrangement. It was practiced throughout the period 1921-37 under the Government of India Act, 1919. The committees and commissions set up at the centre and the states have also suggested simplification of tax-imposing procedures, development of trading enterprises, appointment of State Finance Commission on the pattern of Central Finance Commission. Centralized purchasing, streamlining of financial management etc. are some of the remedial measures to augment finances of local bodies in India. If the suggestions described above are given a serious and fair trial, there is no cause why the shape of Panchayati Raj finances will not improve. These suggestions, when pursued, will go a long way in bridging the gap flanked by needs and present supply of funds, putting Panchayati Raj finances on an even keel.

FINANCIAL ADMINISTRATION OF URBAN GOVERNMENTS

ECOLOGY OF URBAN LOCAL FINANCE

The form of local polity, size and stage of local units, local functions, government control and the economic circumstances of local inhabitants are significant factors which contribute to determining the ecology of local finance. The financial position of the local government is significantly determined through the form of local polity. A decentralized pattern of local government helps the local authority to determine its financial position because it enjoys greater degree of financial independence to levy, assess and collect taxes beside with enough freedom to formulate legislate and execute budgetary proposals. Whereas, a deconcentrated pattern of local government may not help the local government to augment its financial possessions because it allows a lesser degree of financial autonomy in regard to several facets of its financial activities. In this kind of local polity, local government heavily depends on the government for finances. It may also not command better public image and enjoy better position in relation to government when compared with local government in a decentralized polity.

Another significant factor which determines the adequacy of local finance is the size of the local authority. A local unit, big in conditions of its area and population, has a better financial position in comparison to the one that is comparatively small in conditions of physiographic and human settlement. Take for instance, in comparison to a Municipal Corporation, a Notified Area Committee has limited sources of income because of its small area and population. Such kinds of local authorities look to upper stages of government for help to keep themselves financially in a viable condition.

Responsibilities given to the local government are yet another prominent factor for determining the local finance. The government allocates possessions to the local governments commensurate with their functions. Where the local government fails to carry out its responsibilities within the accessible possessions, the government has to either give extra revenue or withdraw such responsibilities. In India, for instance primary education is a local function. But sometimes inadequate local finance does not permit mainly of the local authorities to perform this function inviting government intervention. Moreover, when new responsibilities are assigned to local bodies, adequate funds are made accessible to the local government in the form of government grants.

The financial control exercised through the government is also an significant factor in determining the scope and scale of local finance. The government gives a broad base for local finance through local government Act in respect of sources of income, pattern of expenditure (compulsory and optional), mode of preparation, enactment, and execution of budgetary proposals, custody of funds, accounts and audit. At times, the government comes to the rescue of the local governments for the performance of their responsibilities, in case of insufficient local possessions as well as for their involvement in national obligations. Besides, government also helps the local authority to raise loans, to meet their needs of capital expenditure such as land and heavy machinery.

Last but not least the general poverty of our people is undoubtedly a potent factor in the matter of local finance. People in our country have very little taxable capability. A simple revise of the annul national per capita incomes of countries like — UK, USA, Canada and Japan and that of India will amply prove the point. Therefore, general poverty of people may not help to contribute much towards local revenues.

PRINCIPLES OF URBAN LOCAL FINANCE

The principles which should govern urban local finance are discussed briefly as under: Independence and Responsibility. The principle of independence means that urban government's necessity have freedom of financial operations for fulfilling their obligations. The cannon of responsibility which flows from independence implies that the responsibility for raising and spending money should be with the same authority. The authority which has the pleasing job of spending money should also do the unpleasant job of raising it. Taxing autonomy and spending autonomy necessity go hand in hand.

Adequacy and Elasticity

The principle of adequacy means that the possessions of the urban governments should be enough for discharging the assigned duties. Elasticity means that the possessions should expand in proportionate to their skill to pay taxes. Through uniformity, we understand that the financial system in urban governments should be such as to each urban government to give an adequate stage of public services without resort to rats of taxation considerably higher than those of other urban governments.

Integration and Coordination

The whole financial system of urban governments should be well-integrated and all fiscal arrangements should combine into a constant whole. The integration of central, state and local revenue and expenditure should be done in such a way that promotes development. The coordination of central, state and local finance should not only be in taxation but should also cover the current budget, capital outlay programmes, credit operations of the several authorities and should be accompanied with a coordination of their administrative activities as well.

Public Accountability

In a democratic system, the principle of public accountability means that government should be accountable to the elected representatives who represent the citizens of the country, or the state or the locality as the case may be, for its taxing and spending decisions. After executing the budget, there should be an audit of it through an independent authority and all acts of omissions and commissions through administrative agencies or the executive, if there be any, should also be dealt with severely.

Simplicity

It means procedures concerning preparation, enactment, execution, custody and disbursement of funds, accounts, audit, etc., should be simple and understandable for taking timely action which is essential for efficiency and economy. The absence of simplicity, promptness with caution, regularity of working affects the vitality of financial administration.

Effective Municipal Personnel Management

It means that personnel policies in matters of recruitment, training, promotion, circumstances of service, security of service, conduct and discipline, political neutrality etc., should help on toning up the efficiency of personnel which is essential for managing financial operations.

Fiscal Access

The fiscal arrangements should be such that they provide to urban governments an access to new financial possessions. There should be no bar in developing new sources of income within their own prescribed fields to meet the rising financial needs. The possessions should grow as the responsibilities increase, hence, the need for exploiting new sources of revenue.

MUNICIPAL GOVERNMENT: SOURCES OF REVENUE

In India, finance is the vital problem of urban governments. Adequate finances constitute the life-blood of the whole system of local government. Without enough finances, urban governments become mere subordinate units of state government and fail to cater to the civic needs of the community. Their income is derived from local taxation, enterprises, or the wealth of the citizens, located within the limits of municipal body. Direct taxation is common in municipal fiscal administration. In addition, they impose special levies, commonly termed as “betterment levies” charged for improvements on property made through them. Besides, they receive assistance from state and central governments for discharging their obligatory duties. International agencies through state governments also give financial assistance for projects of urban development, such as, water supply, housing, roads etc. Sources of income of urban governments may be grouped under:

- Tax-revenue
- Non-tax revenue
- Grants-in-Aid, and
- Loans.

Tax-Revenue

The major proportion of income of urban governments flows from taxes. It ranges flanked by two-fifths and three-fourths of total income. The main taxes are:

- Octroi or terminal tax
- House tax
- Tax on trades, professions '
- Tax on dogs
- Tax on advertisements other than those published in the newspaper
- Bazar tax '
- Tax on vehicles
- Tax on theatres
- Toll tax.

Non-tax Revenue

It comprises receipts from rents of municipal property, interest on investments, profit from public utility undertakings like—water supply, passenger transport, electricity supply, fee for issuing licenses or permits, fines realised for offences against municipal bye-laws, rules, regulations etc. For instance in Punjab and Haryana this source of revenue fetches about 30 per cent of revenue. The national average of the proceeds from this source is a little above 30 per cent.

Grants-in-Aid

It is another significant source of income of urban governments in India. Grants represent subsidies given through the state government in aid of sure services rendered through urban governments. Grants can broadly be divided into two categories, namely, recurring and non-recurring. The former are provided through the State Government to meet the gap in their recurring expenditure. The latter are given to municipalities to meet the initial cost of some specific projects such as water supply, school structures, health centre etc. The amount of grant is determined on the basis of the matching formula, per capita income and expenditure etc.

Loans

Urban governments also meet their needs of capital expenditure such as purchase of land, heavy machinery and long-term projects through raising loans. Borrowings are regulated through the central law recognized as Local Authorities Loans Act, 1914. Loans are raised with prior sanction from the state government. In sure cases, the permission of the central government is also needed. The urban governments are permitted to borrow loans from banks, Life Insurance Corporation and other financial institutions. All proposals concerning loans from open market or LIC are required to be cleared, through the Reserve Bank of India. For all practical purposes, urban governments except municipal corporations have to depend largely upon loans from their respective state governments. Every loan has its own rate of interest, term, mode of repayment, measures of utilization etc.

MUNICIPAL GOVERNMENT: EXPENDITURE PATTERN

A municipality can spend on the services permitted to it under the law which may be contained in a public Act of Parliament or State Legislature in a local Act. Besides, the state government may, in the name of public interest, declare any other expenditure to be a legitimate charge on municipal funds. Though the responsibilities of municipal bodies in our country are more or less similar, yet there are wide variations in the middle of the states in the matter of per capita expenditure on dissimilar heads or services. The significant heads of municipal expenditure are as under:

General Administration, Establishment and Collection Charges

This expenditure comprises charges like salaries of employees, maintenance of the charges for the collection of revenue and the construction structure and octroi. The other charges which fall under this head also contain litigation expenditure such as lawyer’s fee, court and witness fee, election expenses for preparing voters list, ballot papers, audit fee for auditing accounts etc.

Public Education

The responsibility of providing free and compulsory education for children until they complete the age of fourteen years is as a matter of fact to be borne through the state governments. (Article 45 of the Constitution of India). But in some states, like Punjab, Bihar, Haryana, Uttar Pradesh, this is being shared through urban governments. These states extend financial aid to urban governments to meet the expenditure. The expenditure on public education falls under two heads, viz., (1) running schools, and (2) setting up and operating public libraries and reading rooms.

Medical and Public Health

Protection of public health is one of the primary functions of urban governments. The public health activities are divided into two parts:

- Provision for medical relief and administration of preventive medicines and
- Maintenance of public health.

Water Supply

Pure drinking water is essential for good health. The provision of pure, clean and adequate water supply is, so, an significant function of urban governments. Expenditure on this head is usually quite heavy because tanks, reservoirs, engines, pipes, taps and other works may have to be constructed and maintained. Besides, the water is supplied at no-profit no-loss basis, in other words, the water is supplied at a less rate than the cost of production.

Municipal Works

It is one of the significant items of the municipal budget. Under this head, the urban government's maintenance of roads, bridges, markets, slaughter-houses, lanes and bye-lanes and any such other works concerning with the physical beautification and development of the city or a town, are sheltered.

Maintenance and Reserve for Unforeseen Emergency

Maintenance expenditure covers property repairs, dismantling unauthorized structures etc. Reserve for unforeseen emergency comprises expenditure on public safety such as fire services, protecting public against stray and dangerous dogs, and any such other emergency which is unpredictable.

URBAN FISCAL MANAGEMENT

It comprises budgetary procedure, procedure for assessing and collecting revenues, custody and disbursement of funds, stores, accounting and auditing. These are discussed as under:

Budgetary Procedure and Authorization

A budget is not almost a statement of revenue and expenditure, it is something more than that. The whole policy of the municipal body is reflected in the budget. It is a tool of management. In Punjab, the Executive Officer is responsible for preparing the municipal budget. In the month of December, the spending and earning departments send to the Accountant their annual estimates containing the (a) actual of the previous year; (b) actual of the current year; (c) revised estimates of the current year; (d) estimates of the ensuing year. After getting the estimates from the dissimilar departments, the Accountant consolidates them and sends the consolidated budget to the Executive Officer for examination. After careful scrutiny of the estimates, the Executive Officer submits proposal to the Finance Sub-committee. After getting the recommendations from the Finance Sub-committee, the budget is placed before the Committee of the whole house for discussion and approval.

Assessment and Collection of Revenues

The Executive Officer is responsible for the assessment and collection of taxes. But in actual practice, the Tax Superintendent assisted through the Tax Inspector prepares the assessment list. An appeal against the assessment of taxes lies with the Deputy Commissioner. The Jurisdiction of the Civil Courts is debarred in matters of assessment. But on points of law the Deputy Commissioner may create a reference to the High Court.

Custody and Disbursement of Funds

In the Municipal Committees, the income received through dissimilar departments is credited every day into the Municipal Treasury. The power of withdrawal of the money rests with the Executive Officer.

At the end of each day, the balance is drawn in cash book which necessity tally with the day's transactions entered in the cash book and the balance of amount in hand. This means practice of the single-entry system that is, the revenue side is credited when any amount is received and debited when paid out.

Stores

Urban Government's stores are divided into two parts, namely, (a) Special stores and (b) General Stores. Special stores consist of article required through a scrupulous department. These are purchased directly according to the necessities of the department. General stores consist of articles which are of general use and are required through general departments. Such stores are purchased through the central stores department. In this way the purchase of wholesale quantity is made at the lowest rate

Municipal Accounts and Audit

Accounts mean a record of money transactions. It may be described as a procedure through which a local body puts all its business transactions on record to coordinate the data in these records, so that they may be used intelligently. Accounts not only enable the local bodies to regularize its administration but also help them in the exercise of proper control over the finances. In Punjab the general methods, the structure of accounts and the manner in which the accounts are to be kept are prescribed in the Municipal Accounts Code, 1930. The instructions of the Examiner, Local Fund Accounts are to be complied with, in respect of details to be furnished through the urban government.

Inseparable from the maintenance of proper accounts of the municipalities is the necessity of their audit. It is of two kinds, namely, pre-audit and post-audit. The former is mannered before the expenditure is incurred on any item. The latter is done after the financial transaction has already been made. In India both kinds of audit are in operation in Municipalities. As a matter of fact it is the municipality which decides the mode of audit in a municipality. The accounts of the municipalities are audited annually through the Examiner, Local Fund Accounts. The cannons of financial propriety are clearly laid down in the Municipal Accounts Code. The main purpose of audit is as under:

- To ensure that the same amount has been spent which was sanctioned in budget.
- To see that the amount has been spent according to rules and regulations.
- To confirm that the amount has been spent for the purpose for which it was granted i.e. the amount sanctioned for the purpose of education has not been spent for public works.
- Check the financial propriety i.e. money has been spent economically and efficiently.
- To see that the amount has been spent with the prior sanction of the competent authority.

STATE CONTROL AND SUPERVISION

Urban local bodies are not sovereign bodies. As mentioned earlier, local government is a state subject and as such state government is empowered to legislate on several characteristics of local bodies. It determines their structure, powers, functions, financial possessions etc. In fact, urban local bodies are regularly controlled, supervised, directed and occasionally penalized through the State Government for their acts of omission and commission. In India, the forms of government control over urban bodies are several and varied. Such control is of four broad diversities, namely, (a) legislative, (b) judicial, (c) administrative, and (d) financial. In this unit, we are mainly concerned with financial control. Government control over the finances of urban governments may be grouped under the following heads.

Control over Taxation

The government is empowered to exempt any person or property from the payment of any tax. Every resolution of a municipality rising or decreasing or abolishing an existing tax, requires the approval of the state government and in sure cases, of central government as well. For instance, in case of tax on profession, the Constitution of India had prescribed a limit of Rs. 250 per annum in 1949. In view of the price rise and other factors some state governments when demanded through local bodies, had to request the centre to revise the ceiling. The rate was, so, enhanced to Rs. 2,500 per annum in 1988 through the Sixtieth Amendment Bill of the Constitution. The state government is empowered to suspend or prohibit, or remedy a tax unfair in incidence or injurious to the interests of the general public.

Besides, the state government can direct a municipal body to impose octroi on a scrupulous items at a scrupulous rate instructed Ludhiana Municipal Corporation in 1986 to levy octroi on man-made fibers like nylon and terrene and hand knitting yarn made out of nylon fiber at the rate of rupees 2.10 per 100 rupees. State government may allow urban bodies to add supplementary rates to the existing government taxes. For instance, in India, when state governments had abolished octroi, they permitted the urban governments to impose a surcharge on the sales tax which is a state tax.' Besides, a local tax may be administered through the government, although it is actually enjoyed through the urban governments. For instance, in Andhra Pradesh entertainment tax which is basically a local tax is imposed through the government but the whole proceeds are given to urban governments after retaining the collection charges amounting to Rs. 5 per unit of the collections. Likewise, from motor vehicle tax, which was formerly a local tax in India, sure percentage of the collections are made over to the urban authorities through the state governments.

Control over Municipal Expenditure and Fund

The state government is empowered to regulate municipal expenditure through fixing limits on expenditure to be incurred on several items, laying down regulations and procedures for incurring expenditure. If the work involved exceeds a scrupulous limit of expenditure, the urban bodies are required to obtain administrative and technical sanction from the competent authorities as determined through the state government. It can also require a municipal body to pay for any service. The purposes to which municipal fund can be applied are specified through the State Government through an Act and its application to any other purpose requires the government approval.

Control over Budget

The urban bodies are required to prepare their budgets in the manner and form as determined through the state government from time to time. The budget approved through the municipality cannot be executed without the prior sanction of the state government which in turn has the power to create alterations in budgetary proposals. As mentioned in the preceding section if municipality does not agree with the modifications made, the decision of the state government is final and binding on the municipality. In some states, the budget is not subject to the sanction of the state government. In such states the approval is needed only in those cases where municipalities are indebted. Besides, prior sanction of the state government is also needed for re-appropriation from one head to another head of the budget, that is, the money granted for education can be put to use for public works with government approval.

Control over Loans

As mentioned earlier, the borrowing powers of urban bodies are regulated through the central law recognized as the Local Authorities Loans Act, 1914. Before approving any proposal to borrow, the state government thoroughly examines the scheme, reviews the whole financial position of the urban local body, fixes the period of repayment, determines the mode of borrowing etc. For instance, the Uttar Pradesh Nagar Mahapalika Adhiniyam, 1959, lays down the following restrictions:

- No loan can be raised unless the state government has approved the purpose, amount, rate of interest, date of floatation, period of repayment and method of repayment of loans.
- The period within which the loan is to be repaid shall, in no case exceed 30 years.
- Without the prior sanction of the Government no part of the amount borrowed shall be applied to any purpose other than that for which it was borrowed.
- No portion of the sum borrowed shall be applied to the payment of salaries or allowances of any municipal officer or servant other than those who are exclusively employed on the work for construction for which the money was borrowed.
- No loan can be raised for the execution of any work other than a permanent work.

Control over Grants .

Grants-in-aid are the mainly effective instrument of state control over the finances of municipal bodies in India. The state government ensures that the grants are properly utilized and not misappropriated or diverted to unapproved purposes. The grants can ’ be reduced, suspended, and withheld if the accompanying circumstances are not fulfilled through a municipal body.

Control over Accounts and Audit

Accounting and auditing are significant instruments of state control over municipal finances. The municipal bodies maintain accounts in the form and manner as prescribed through state government. As stated earlier, in Punjab, the municipal bodies are required to follow the Punjab Municipal Accounts Code, 1930, which lays down detailed procedures for all sorts of financial transactions. Any departure from the form and manner requires the sanction of the state government. Besides, the state government may at any time direct special examination and conduct audit of municipal bodies through Auditors appointed through the state government. The main aim of the state government control through an audit is to ensure that public money is properly utilized and no amount is paid for any expenditure without the proper authority and provisions of the funds in the budget.

GAP FLANKED BY MUNICIPAL SERVICES AND POSSESSIONS

The municipal possessions are mainly based on the sharing of functions flanked by the State Government and the Local Government. The functions of the urban governments are specified in the Act under which they are recognized. The municipal functions are categorized as compulsory and optional. In order to discharge obligatory functions budgetary provision is made for them. If urban bodies fail to perform obligatory functions, the state government helps them either through providing grants-in- aid or arranging long-term loans to meet the needs, subject to their repayment. Though, an analysis of the municipal possessions shows that there is a wide gap flanked by the municipal services and possessions.

In India, the whole field of municipal possessions, remarks one commentator “is replete with outmoded principles of political economy, with stultifying checks and with consequential discouragement.” There is an overall lack of appreciation of the fact that adequacy of financial possessions and efficiency of financial management are determinants of the tone of municipal administration. The causes of inadequate municipal possessions are of varied character. The whole machinery of municipal tax administration suffers from serious defects such as poor collection, heavy arrears, leakage of revenue, corruption, evasion in taxes, improper assessment of taxes etc. Further, the municipal personnel are low-paid and lack necessary training and experience. It has been observed that the local staff concerned with the assessment of taxes is usually not fair and the principle of equity is often disregarded. For instance, the Tax Superintendent being responsible to the members of the municipal committee is usually inclined to assess the houses of influential persons and the members at a low rate.

In spite of the audit of municipal accounts, the audit has remained ineffective and inefficient. Except in big municipalities, audit is not mannered regularly. It is usually in the nature of post-mortem examination which is sometimes dubbed as “locking the stable after the horse is stolen.” Again audit objections and reports remain uncared for, at year’s end. Therefore the very purpose of the audit is frustrated.

The borrowing powers of the urban local bodies in India are also limited. The term of re-payment and the rate of interest on loans are unfavorable in comparison to developed countries of the World. Further, mainly of the sources assigned to municipal bodies for taxation are inelastic and cannot give the required services for the rising activities of these bodies. For instance, taxes like octroi, terminal and property which constitute the backbone of municipal finance are quite inelastic as the proceeds from them do not grow in proportion to the growth in financial necessities. The rules and procedures governing the imposition of taxes etc. are very elaborate, cumbersome, time consuming and leave very little financial independence to municipal bodies. Besides, the powers of the Indian local bodies to levy is limited through the Constitution of India. For instance, Art. 285(2) of the Constitution exempts the Central Government properties from the levy of local tax through municipalities.

One of the contributing factors to the poor municipal possessions is that the government grants are utterly inadequate, unrelated to needs, irregular, unsystematic and uncertain in their release to municipal bodies. In some states, like Punjab and Haryana, government has taken over some of the municipal functions or the administrative control thereof as in the case of education and fire-brigade but the expenditure pertaining to these functions is largely borne through the municipal bodies. This is wholly unfair and unbusinesslike. Another important cause for inadequate financial possessions is the unwillingness of municipal bodies to mobilize their possessions to the admissible limit and to use even the limited powers of taxation that they have. They have, usually, shown utmost reluctance in rising the existing taxes or in imposing new ones even where advisable and feasible, especially the direct taxes, for fear of people's anger and resentment.

Separately from the above mentioned causes for the unsatisfactory position of municipal possessions the other reasons are: underdeveloped trading enterprises, increased population pressure, general poverty in India, increased responsibilities, increased cost of municipal services because of ever soaring prices of the material and enhanced wages of the municipal personnel, and so on. If the municipal government is to play its role commensurate with the expectations and aspirations of the people, a serious effort is to be made to ensure its financial soundness so that the gap flanked by the municipal services and possessions is reduced. A number of committees and commissions have examined the question of the adequacy of municipal possessions in India since independence. It has been suggested that the prevalent reluctance of municipalities to introduce taxes has to be overcome.

The local Finance Enquiry Committee (1949-51) rightly recommended "Local bodies which do not utilize their existing power of taxation can have no claim on the financial possessions of the state, where a local body is unwilling to impose tax at an adequate rate, the state government should have the right, in first instance, to provide friendly advice and if the local body fails to carry it out, the state government should in the last resort, have the power to impose or raise the taxes. To augment the possessions of municipalities, the financial management of these bodies needs to be streamlined, through selecting municipal personnel on merit, imparting them adequate training, paying them competitive salaries etc. Separately from this, there should be a strict check on the corrupt and defaulting employees. Efforts should also be made for the proper assessment and collection of taxes. Incentives may be offered for prompt payment of taxes and heavy fines may be imposed on the tax defaulters. Besides, audit should be mannered more regularly and special provisions even punitive in nature should be made for the speedy disposal of audit objections.

The suggestion of the Rural-urban relationship Committee (1963-66) to set up a Municipal Finance Corporation in each state to give loans to the municipal bodies for developing municipal enterprises such as city transport, milk supply etc., needs serious consideration through the State Government. Keeping in view the suggestion of Central Council of Local Self Government it is in the fitness of things to appoint a Municipal Financial Commission on the pattern of Finance Commission at the national stage to look at in detail the financial necessities of municipal bodies, laying down the principles of sharing sure taxes flanked by the state and municipal bodies. The financial obligations arising from the recommendations of the Municipal Finance Commission may be placed before Central Finance Commission, appointed through the President under Art 280 of the Constitution. A number of State Governments have set up Municipal Finance Commissions, Maharashtra

(1973) being the first followed through Orissa (1975). A state where such a commission has not been set up should consider this suggestion as early as possible.

To improve the financial position of municipal bodies, government grants should be adequate, related to needs, regular, systematic, sure and be made accessible to them over the after that five years or over the plan period. The borrowing circumstances should be liberalized in sure ways such as longer conditions of repayment, cheaper interest rates, extension in purposes and permission with adequate safeguards to borrow in the open market. This will go a long way to meet mainly of the pressing needs of the capital nature for funding long-term and costly projects like water works, slum clearance etc. Last but not the least, the other suggestions such as a centralized purchasing, simplification of tax-imposing procedures, over-handling taxation structure, development of municipal enterprises, eradication of general poverty, and the proposal of the late Mr. Rajiv Gandhi, former Prime Minister of India to grant Constitutional status to municipalities should also, be kept in mind. All the above mentioned suggestions need the sincere and serious thoughts of the State Government and if accepted and implemented will surely help to bridge the gap flanked by the municipal services and possessions. The sooner it is done, the better it would be.

REVIEW QUESTIONS

- What operations are involved in financial administration of rural local government? How are these performed?
- Discuss the significant principles that govern rural local finance.
- Point out the sources of revenue of Panchayati Raj Institutions.
- Discuss the significant factors which contribute for determining the ecology of local finance.
- Describe briefly the principles which should govern the local finance.
- Explain the sources of income of urban government.

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