

## CHAPTER-1

### Introduction

1.1 Current budgetary process has evolved in India through the quest for rebuilding a strong nation in the post independence era. The role of the governments across the world has since undergone many changes. So have the expectations of citizenry from the Governments. Processes of growth and development in societies have also witnessed paradigm shift. In this changed milieu, the expectations from government budgets and accountability of those involved in the process have multiplied manifolds. The budget now has to evolve as an instrument efficiently and adequately addressing the emerging challenges. Budgets of the day cannot continue to be mere resource allocating mechanisms shrouded in mystery but a well rolled out, transparent, stable action plan woven around a growth perspective, matching citizens' expectations.

1.2 In India, as in many other countries of the world, preparation and presentation of annual financial statement, or what is commonly known as budget, is a constitutional responsibility of the executive. **Article 112** of the Constitution is quite unambiguous about this responsibility in stating that the President shall in respect of every financial year cause to be laid before both the Houses of Parliament

a statement of the estimated receipts and expenditure of the Government of India for that year. **Article 202** of the Constitution lays down a similar responsibility upon the Governor of a state with regard to annual financial statement of a state. As the Constitution provides for the procedures in financial matters separately for the Union and the States, there is no superior-subordinate relationship between the two when it comes to matters relating to budgeting. This should not be construed to imply that there are no linkages between the budgetary processes of the Union and the States, as is the case between the Union Budget and the budgets of municipalities or rural local self Governments. **In this study, we are going to concentrate on the budgetary process of the Union**, and reference to budget of State Governments would be restricted to the extent it has linkages with the Union budget.

### *The Problem*

1.3 Despite various attempts at reforming the system, formulation of budget continues to be a routine activity with the revenues and expenditure being estimated on traditional incremental basis. Estimation of expenditure and revenues suffers from *ad hocism* and is not based on any scientific techniques. As a result the estimates are often unrealistic and inaccurate. Budgeting in India is based on the traditional 'bottom-up' approach, which means that all agencies and ministries send requests for funding to the Finance Ministry. These requests greatly exceed what they realistically believe they will get. Budgeting then consists of the Finance Ministry negotiating with these ministries and agencies until some common point is

found. Such a system is time consuming and has an inherent bias for increasing expenditure.

1.4 In this tug of war between the Ministry of Finance and the line ministries the power equation favours the former. The line ministries in Government of India have time and again made out a case for relaxation of control by the Ministry of Finance. Despite attempts of Ministry of Finance to relax its hold over the project / scheme wise allocation of funds within line Ministries there is little flexibility that the line ministries enjoy.

1.5 The most serious limitation of the budgetary process of Government of India is, perhaps, lack of focus on results. Union budget continues to be input based despite adoption of concepts like output budgeting and Zero Based Budgeting. Accountability is at best measured in terms of compliance with rules and procedures. Attempts to introduce result-based system have not made much headway and successful implementation of the budget by any ministry/department is still measured in terms of ratio of actual expenditure to budget estimates. This limited measure of accountability is further flawed because what is seen as actual expenditure may only be a release of funds by the ministry to implementing agencies/field formations, the State Governments, Public Sector Undertakings, and Autonomous Bodies etc. where the funds might remain unutilized for an

unaccounted period. Compilation of General budget has till date no organic linkages with outcome budgets of individual ministries.

1.6 Till recently a serious limitation of the budgetary process was that the budget documents did not give the assumptions underlying the budgetary forecasts. There is no single key factor that can derail the fiscal consolidation programmes more than the use of incorrect economic assumptions. Great care must be taken in making economic assumptions and these assumptions should be explicitly disclosed in the budget documents. Sensitivity analysis should be made of what impact changes in key economic assumptions would have on the budget. The provisions of the FRBM Act 2003 require disclosure of such assumptions in the Medium-term Fiscal Policy Statement but the Act does not provide safeguards against use of unrealistic or optimistic economic assumptions. Even countries like Canada and Netherlands which are way ahead in the race of fiscal transparency have faced harrowing experiences because of use of unrealistic assumptions and have now started using systematically-biased "prudent" economic assumptions.

1.7 There is significant variation between most of the budgeted figures and actuals each year but the budget documents fail to bring out these deviations. It is not possible to draw any meaningful conclusions from the data given in the budget documents of a particular year as the estimates are given for the current year and next year while the actuals pertain to the previous year. Moreover, the budget of Government of India is based on the doctrine of lapse i.e. the unspent amounts

under each grant lapse on the last day of the financial year and can not be carried forward to the next year.

1.8 An underlying principle of budgeting is that all revenues earned by any ministry / department or government entity have to first enter the consolidated fund wherefrom they can be allocated back to the concerned ministry / department through parliamentary appropriation. Contrary to these accepted principles, there is a tendency on the part of the ministries / departments to either hold back the revenues earned by them, rather than route the same through the consolidated fund, or to create reserve funds in the Public Account, to which huge amounts are transferred at the beginning of the year so that these funds do not lapse on 31<sup>st</sup> March. There are several such funds in operation and, of late increasingly large amounts are being transferred to these funds. Year after year, the reports of the Comptroller and Auditor General point out how a chunk of the allocations are utilized by the ministries/departments in the month of March or even on 31<sup>st</sup> of March in order to avoid surrender of unspent balances. Comptroller and Auditor General has repeatedly cast doubts about efficacy and propriety of such expenditure. In fact, in his Report No. 1 of 2004 on the accounts of the Union Government the Comptroller and Auditor General has stated that rush of disbursements, particularly in the closing month of the financial year is to be regarded as a breach of financial regularity and should be avoided.

1.9 Estimates of revenue, besides suffering from *ad hocism*, are shrouded in secrecy. Inadequate empirical database and unscientific projection techniques characterize the forecasts of tax revenue as well as non-tax revenue. There is a crying need for greater transparency in revenue projections, particularly tax revenue which constitutes more than three fourth of the total revenue receipts of the Government of India. The secrecy that shrouds the tax estimates creates uncertainty as well as an unfair advantage for those who somehow manage to break through the veil and get a glimpse of the proposals. Provisions of Provisional Collection of Taxes Act, 1931, which enable the Finance Bill proposals to become effective immediately on introduction, reduce the scrutiny of tax proposals to a mere post-mortem exercise. This also is the root cause of the innumerable amendments that are normally carried out to the Finance Act in the wake of debate in the Parliament. More indefensible is the need to keep the expenditure estimates secret. **The Fiscal Responsibility and Budget Management (FRBM) Act, 2003** now obligates the Government to bringing about greater transparency in the budgetary process and to make the exercise more participative. But, it needs to be seen as to what difference it has actually made on ground in making budgets less opaque.

*Rationale, significance or need for the study*

1.10 Budget is and will continue to remain the most important fiscal tool in the hands of the government to achieve its development objectives. While the Five year

Plans are the blue-prints for long term planning the annual Financial Statements are statement of Government's intent in the short run. The objectives and allocations proposed in the plans need to be broken down to disaggregated annual targets for concrete action to be initiated by the line ministries and departments. Hence, budgetary process and annual allocations acquire a significant place in translation of fiscal policy statements into reality. It is thus not surprising that budgetary reforms have time and again attracted attention of the government.

1.11 In recent years the need to reform the budgetary process and to attain a certain degree of fiscal responsibility has been evident from many actions of Government of India. Government's endeavour in recent times has been to bring about greater transparency in budget management and to use budget as an important vehicle of growth and allocative justice. Government of India has initiated a number of reforms towards this end. Enactment of the 'Fiscal Responsibility and Budget Management (FRBM) Act' 2003, is perhaps the single most important step in this direction.

1.12 There is a crying need for evaluation of relevance and efficacy of these reforms. In this dynamic world where fiscal needs and compulsions continuously evolve, it is important to examine and analyse the response of Government to changes in the fiscal scenario. The need for such an independent evaluation has become even more pertinent after the recent global meltdown which has catapulted

Government's fiscal and monetary policy to the centre stage by denting the believe once again that invisible hand of the market would lead to *Pareto optimality* in all sectors at all times. This study proposes to attempt such an evaluation.

*Statement of the problem and theoretical framework for the proposed study*

1.13 This study is an attempt at examine the budgetary process in Government of India with particular emphasis on impact of enactment of the FRBM Act. The aim is to try and trace the process of budgeting in government of India and to ascertain the problems that plague the process. Further, the study also attempts to ascertain the rationale behind what has been perceived by many as the most important budgetary reform i.e the FRBM Act 2003 and to study to what extent the underlying objectives of this legislation have been achieved.

1.14 This study is concerned only about the process of budgeting in Government of India. It attempts to answer questions like what is the process of budgeting mandated by our Constitution, are budgets of Government of India being prepared in accordance with the mandated legislative process, is the process based on best international practices and is the process efficient and transparent. This study does not propose to go into the normative aspects of budgeting like which sectors should be given priority in budgetary allocation and whether the government should



concentrate on the objective of growth or distributive justice while framing its budgets, etc.

1.15 Another important objective of this study is to track the changes in the process of budgeting in the light of the FRBM Act. FRBM Act is certainly the most defining reform that the Government of India has initiated as it encompasses almost every aspect of the budgetary process to bring it in tune with the best practices in the world.

1.16 FRBM Bill was introduced in the Parliament, in December 2000, with the stated objective of putting in place a mechanism to promote overall fiscal prudence and remove impediments to the effective conduct of monetary policy and debt management. Enactment of the FRBM Act 2003 was a step in the process of fiscal consolidation and reform programme as it was intended as means to ensure intergenerational equity, long-term macro economic stability and growth for India. This Act was also expected to bring about transparency in institutional arrangements and fiscal reporting.

1.17 The FRBM Act not only mandates minimum quantifiable targets for reducing the growth of debt, deficit and guarantees in a time bound manner but also embeds a series of improvements in the area of fiscal transparency and medium-term fiscal planning to improve budget management. This should catalyse the process of true

democratic control of fiscal policy through informed public opinion on the risks inherent in unabated growth in debt and deficit. (Panigariya, Arvind. India, the Emerging Giant. Oxford University Press, 2008)

1.18 The FRBM Act has its supporters as well as its detractors. While a set of economist and fiscal specialists have hailed it as a revolutionary step towards making budgets more responsible and transparent, there are others who view it as the biggest impediment to the planned development process. The government having enacted the Act seems to be dwindling on its commitment to the legislation. The study will try and see whether the FRBM Act 2003 has been implemented in all earnestness and whether it has had the intended impact on the budgetary process of Government of India.

1.19 The 11<sup>th</sup> Finance Commission advised state governments to pay attention to the system of budgeting and budgetary control for finding an enduring solution to the problem of budget deficits. Following the recommendations of 11<sup>th</sup> Finance Commission a number of state Governments enacted state level fiscal responsibility legislation committing themselves to time bound targets relating to fiscal deficit and revenue deficit etc.

*Key questions to be investigated*

Budget is undoubtedly the most important fiscal tool for any Government for attainment of its fiscal policy objectives. The extent to which it is effective depends

largely on the budgetary intent and process. In this study we are going to look at the budgetary process of Government of India, assuming that the intent of the government is to achieve its long term fiscal goals as laid out in the plan documents and as stated from time to time in other policy documents. Without going into the intent of Government, we are going to examine the budgetary process and evaluate the impact of FRBM Act 2003 enacted by Government of India to reach higher levels of fiscal consolidation and responsibility. **The major research questions that the study intends to address are:**

- I. What is the process of Budgeting in India and how has it evolved?
  - i. What are the legislative provisions relating to budgeting in India?*
  - ii. What has been the practice on ground?*
  - iii. What are the general limitations of the budgetary process in India?*
  - iv. What attempts has Government of India made to address these limitations?*
  
- II. To what extent the enactment and implementation of the FRBM Act 2003 has reformed the budgetary process in India and brought about greater fiscal responsibility?
  - i. What was the rationale for and objectives of the FRBM Act 2003?*
  - ii. Has the Government of India implemented the Act in letter as well as spirit?*
  - iii. To what extent have the objectives of the Act been achieved?*

*Delimitations and limitations of the study*

1.20 The subject matter of the study is vast, thus, to get meaningful results we need to clearly define the boundaries of the study. Budgetary reform is a continuous and dynamic process. The world has seen innumerable attempts at improving the process of allocation of resources to get more meaningful and productive results out of the exercise of budgeting. The public sector and the private sector have spent considerable resources and time over honing the skill of budgeting. In the current study we shall restrict ourselves strictly to budgeting by the Government.

1.21 Keeping in view the available time and resources which are the limiting factors, geographically the study will be limited to India and conceptually to budgeting within government of India. Comparisons with budgetary reforms internationally are inevitable but these would be limited to study of international experience only to the extent that the reform programme in these countries have acted as models for Indian framework or have impinged upon the budgetary model of Government of India.

1.22 As stated earlier the process of budgeting at the state level, although linked to the Union budget is an exercise independent of budgeting in Government of India.

But, because of time and resource constraints, budgetary processes and reforms at the state level have also been kept outside the Purview of this study.

1.23 Further, within Government of India, this study is going to be limited to examination of the budgetary process and will not go into the normative question of pattern of allocation of resources between different competing sectors. Often it is stated by critiques that the Government is trying to politicize the budget. The starting point of this study is acknowledgement of the fact that budget is, indeed, a political document and the budgetary process is a method of allocation of resources according to the political agenda of the Government, based on which it has come to power. But as stated earlier, this study is not going to visit the political or normative question of how the resources ought to be allocated between the various sectors. Implication of this limitation being that the study does not intend to deal with questions like should the Government spend more on health and education, or what portion of Gross Domestic Product(GDP) should be allocated to defence etc .

1.24 Within Government of India, time and again budgetary reforms have been attempted and ways and means found to bind the government to greater fiscal discipline. But, as mentioned above, this study will be limited to examining the impact of enactment of the FRBM legislation, aimed at bringing about structural reforms in the way Government of India exercises its fiscal policy. Again

budgetary reforms and fiscal responsibility legislations enacted at the state level are not a subject matter of this study.

### *Research Procedure*

1.25 This study will be based on collection and analysis of existing literature and data relating to the research questions under study. There exists a reservoir of information both at the international and national level which can be effectively tapped for the purpose of this study. The data relating to fiscal health of India and related issues can easily be culled out of budget documents, C&AG's Audit Reports, Plan documents, RBI publications, Economic Survey etc. literature review reveals presence of a large number of books, articles, studies etc dealing with issues with which this study is concerned. The decision to rely mainly on existing data is due to limitation imposed because of time and resources and more importantly because a large pool of fairly reliable data is readily available.

1.26 While the study will depend mainly on existing secondary data, effort will be made to obtain some primary information through interviews, interactions etc. The interviews will be open ended but structured. It is proposed to interview Government officials dealing with budgeting in Government of India, officials from the C&AG's outfit as they are responsible for auditing the financial statements and accounts of government of India.

1.27 The impact of FRBM Act will be measured in terms of achievement of the stated targets (Act and Rules) and objectives of the legislation. This exercise will be based on trend analysis of important fiscal parameters, data for which is readily available in budget documents, FRBM documents placed before Parliament, Economic Survey, Mid-Term reviews etc. The analysis of the extent of achievement of objectives of the fiscal responsibility legislation and their impact on the budgetary process will be based on objective assessment of empirical evidence and subjectivity will be assiduously avoided.

1.28 This study is both descriptive and analytical in nature. It is descriptive to the extent that it tries to trace the journey of the budgetary process in Government of India, keeping in view the legislative provisions and the actual practices on ground. It is analytical to the extent that it tries to identify the major limitations of budgetary process based on study of actual practices and empirical evidence. Further, the analytical framework of the study becomes highly pronounced when it attempts to study the impact of enactment and implementation of the FRBM Act 2003.