Enabling Inclusive Development

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In this issue

Editorial

Dear Readers,

I would like to firstly wish a very Happy New Year to all of you and with that, welcome you to the fourth edition of 'Public Finance Quarterly', the quarterly newsletter of PwC's Public Finance (PF) Practice. Just as managing finances is a critical function of management in any organization, similarly public finance management is an essential part of the governance system. The arena of public finance constitutes collection of resources from the economy in an appropriate manner as well as allocating and using these efficiently and effectively. Resource generation, resource allocation and expenditure management are thus the essential components of **public financial management**. In the light of emerging considerations for "value for money" in public resources, public finance management has lately become an integral component of governance.

In the 'Feature Article' section of this edition, a study on the financial impact of the recently implemented 'Right to Education Act' on the states' debt position has been conducted. It is observed that a 'one size fit all' approach for all states with respect to the sharing pattern of expenditure between state and centre may result in many states failing to meet the fiscal norms laid down by the 13th Finance Commission.

In the 'Pick of the Quarter' section, the authors present a view on the Indian budgetary expenditure classification system and argues for further strengthening of Revenue-Capital categorization while doing away with Plan-Non-plan expenditure distinction.

Continuing forward with our role in keeping our readers updated and informed about developments in the public finance domain across the globe, news updates and key paper releases during the last quarter along with their reference links have been provided in the 'Round the Corner' section.

I would like to thank all our readers for their overwhelming support and response to our previous issues. If you have an item to contribute for the next issue or want to subscribe to the newsletter or would like to give your comments/suggestions, please do not hesitate to contact me at **ranen.banerjee@in.pwc.com or our editorial team** whose coordinates are provided at the end of this Newsletter.

We look forward to your comments, suggestions, and contributions!

Sincerely,
Ranen Banerjee
Executive Director - Public Finance

Round the Corner

Quarterly Stock of News Bytes and Releases

News Bytes

Creation of Financial Stability and Development Council (FSDC)

Finance Ministry, India
on 30th Dec, 2010

With a view to establishing a body to institutionalise and strengthen the mechanism for maintaining financial stability, financial sector development and inter-regulatory coordination, the Government of India in consultation with the financial sector regulators took the decision to set up the Financial Stability and Development Council. Creation of the very Council was announced in the GoI's Budget Speech of 2010-11. The Council subsumes the High level Coordination Committee on Financial Markets, an interregulatory body of all financial sector regulators that was headed by the RBI governor.

Link: http://finmin.nic.in/the_ministry/dept_eco_affairs/capital_market_div/Financial_stability.pdf

Release of first Budget Manual of the Union Government

Finance Ministry, India
on 28th Sep, 2010

Union Finance Minister Pranab Mukherjee released the first Budget Manual of the Union Government. The Manual has been prepared by the Budget Division of the Department of Economic Affairs. This comprehensive document is expected to serve as a guidance document to the officials involved in Budget making in the Finance Ministry and other Ministries/Departments, as well as a reference document for interested readers and stakeholders.

Link: http://finmin.nic.in/the_ministry/dept_eco_affairs/budget/Budget_Manual.pdf

Approval of the Mid Term Appraisal for Eleventh Five Year Plan 2007-2012

Planning Commission on 24th July, 2010

The Mid Term Appraisal of Eleventh Five Year Plan as approved by National Development Council is a report card on the achievements midway during the Eleventh Five Year Plan period. The appraisal gives an idea of how far the Government has been able to meet the stated objective of faster and more inclusive growth.

Link: http://planningcommission.gov.in/plans/mta/11th_mta/pdf/MTA_comp11th.pdf

Releases

Fiscal Policy Issues for India after the Global Financial Crisis (2008-10)

Working Paper of Sep 2010 of ADB Institute, Authors: Rajiv Kumar, Alamuru Soumya

The need for fiscal consolidation and sustainability is one of the key macroeconomic issues confronting Indian economy. This paper attempts to understand India's current fiscal situation, its likely future development, and its impact on the economy in the context of a weak global recovery from the current crisis. The impact of the global crisis has been transmitted to the Indian economy through three distinct channels, namely: the financial sector, exports, and exchange rates. The other significant channel of impact is the slump in business and consumer confidence leading to decrease in investment and consumption demand. The Indian government, to boost the demand, has announced several stimulus packages. However, there is not much room for further fiscal policy action as the consolidated fiscal deficit of the central and state governments in 2009–2010 is already about 11% of the gross domestic product (GDP). Any further increase in the fiscal deficit to GDP ratio could invite a sharp downgrading of India's credit rating and a loss of business confidence. The paper reviews the existing theories on the relationship between fiscal deficit and growth. It also analyzes the past trends and policy measures to understand the possible implications for economic recovery and long run growth in the Indian context. It also provides a long-term forecast of the fiscal deficit and public debt burden based on the past trends. Finally, the paper suggests a set of policy measures to get the Indian economy back on the path of sustained rapid and inclusive growth.

Link: http://www.adbi.org/files/2010.09.17.wp249.fiscal.policy.issues.india.after.gfc.pdf

Political economy of infrastructure spending in India

Policy Research Working Paper of Sep 2010 (Development Research Group of World Bank), Authors: Stuti Khemani

This paper examines a puzzle in the political economy of infrastructure in India - the co-existence of relatively low shares of capital spending in public budgets alongside evidence of large demand for village infrastructure from poor voters. It argues that this pattern is due to infrastructure projects being used at the margin for political rent-seeking, while spending on employment and welfare transfers are the preferred vehicles to win votes for re-election. New suggestive evidence on the variation of public spending composition across states, and within states over time is offered that is consistent with this argument. This evidence underscores a growing argument in the development literature that the level and composition of public spending per se may not be sufficient metrics to assess the quality of public goods policies. Greater infrastructure spending in some contexts may go to political rents rather than to the actual delivery of broad public goods for growth and poverty reduction.

Link: http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2010/09/16/000158349_20100916114657/Rendered/PDF/WPS5423.pdf

IMF Technical Notes & Manuals

1. Evaluating Government Employment and Compensation Sep 2010 (Fiscal Affairs Department, IMF), Authors: Benedict Clements, Sanjeev Gupta, Izabela Karpowicz, and Shamsuddin Tareq

This note provides criteria for evaluating government employment and compensation and options for reform.

- The first section discusses the various quantitative indicators that can be used for country analysis and provides an assessment of differences across regions and country groups.
- The second section addresses short- and medium-term options for reform and country experiences.

The note underscores that technical analysis of employment and compensation issues must be accompanied by judgment to weigh the trade-offs between competing objectives. As such, a case-by-case approach is needed.

Link: http://www.imf.org/external/pubs/ft/tnm/2010/tnm1015.pdf

2. Government Cash Management: Its Interaction with Other Financial Policies

July 2010 (Fiscal Affairs Department, IMF), Authors: Mike Williams

This note addresses the following main issues:

- What good practice in government cash management means; and how it interacts with other policies.
- Why close coordination or integration between debt and cash management is important.
- How in practice cash managers can develop more active policies; the potential benefits of that to financial market development; and its implications for monetary policy.
- What this means for institutional structures: for debt and cash managers, and for their interaction with the central bank.

Link: http://www.imf.org/external/pubs/ft/tnm/2010/tnm1013.pdf

A Diagnostic Framework for Assessing Public Investment Management

Policy Research Working Paper of Aug 2010 (World Bank), Authors: Anand Rajaram, Tuan Minh Le, Nataliya Biletska and Jim Brumby

This paper provides a pragmatic and objective diagnostic approach to the assessment of public investment management systems for governments. The paper begins with a description of eight key "must-have" features of a well-functioning public investment system:

(i) investment guidance, project development, and preliminary screening;
(ii) formal project appraisal;
(iii) independent review of appraisal;
(iv) project selection and budgeting;
(v) project implementation;
(vi) project adjustment;
(vii) facility operation; &
(viii) project evaluation.

The emphasis is placed on the basic processes and controls (linked at appropriate stages to broader budget processes) that are likely to yield the greatest assurance of efficiency in public investment decisions. The approach does not seek to identify best practice, but rather to identify the "must have" institutional features that would address major risks and provide an effective systemic process for managing public investments. The authors have also developed a diagnostic framework to assess the main stages of the public investment management cycle. In principle, the identification of core weaknesses will allow reforms to focus scarce managerial and technical resources where they will yield the greatest impact. In addition, the framework is intended to motivate governments to undertake periodic self-assessments of their public investment systems and design reforms to enhance the productivity of public investment.

Link: http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2010/08/09/000158349_20100809092806/Rendered/PDF/WPS5397.pdf

What do Public Financial management assessments tell us about PFM reform?

Background Note of July 2010 (Overseas Development Institute), Authors: By Edward Hedger and Paolo de Renzio

This purpose of this note is to take stock of current knowledge on the topics relating to PFM assessments. It reviews the sources of data on PFM performance and the resulting findings. It further considers what is already known about the factors influencing PFM reform, factors underpinning successful PFM reforms and thus assesses the implications for future reform efforts, while also draw some implications for the role of donor agencies in PFM reform processes.

Link: http://www.odi.org.uk/resources/download/4824.pdf

Budget Consolidation: Short-Term Pain and Long-Term Gain

Working Paper of July 2010 (IMF), Authors: Kevin Clinton, Michael Kumhof, Douglas Laxton and Susanna Mursula

The paper evaluates the costs and benefits of fiscal consolidation using simulations based on the IMFs global DSGE model GIMF. It finds that over the longer run, well-targeted permanent reductions in budget deficits lead to a considerable increase in both the growth rate and the level of output. The gains may be enhanced by shifting some of the tax burden from incomes to consumption. It further mentions that in the short run, credibility plays a crucial role in determining the size of initial output loses. Global current account imbalances would be significantly reduced if budget consolidation was larger in countries with current account deficits.

Link: http://www.imf.org/external/pubs/ft/wp/2010/wp10163.pdf

Feature Article

Gaining an insight into Public Finance Arena

Right to Education Act: Impact on State Finances

Introduction

"We are committed to ensuring that all children, irrespective of gender and social category, have access to education. An education that enables them to acquire the skills, knowledge, values and attitudes necessary to become responsible and active citizens of India."

With the above speech, the Prime Minister of India, Dr. Manmohan Singh laid down the foundation of the Children's Right to Free and Compulsory Education Act in India.

One of the most inalienable human rights is the right to education which is enshrined in Article 26 of the Universal Declaration of Human Rights. In India, Article 45 of the Constitution originally mandated the State to provide free and compulsory education to children between the ages of six and fourteen years as part of the Directive Principles of State Policy; but after the 86th Amendment in 2002, this has been converted into a Fundamental Right (Article 21A) and Article 45 is replaced by an obligation upon the State to secure childhood care to all children below the age of six.

Against this backdrop, the Right of Children to Free and Compulsory Education Act or Right to Education Act (RTE) was passed by the Indian parliament on 4 August 2009. As per the provision of RTE, after 1st April 2010 every child has his or her right (as an entitlement) to get a quality elementary education, and that the State, with the help of families and communities, fulfils this obligation. Moreover, there is no direct (school fees) or indirect cost (uniforms, textbooks, mid-day meals, transportation) to be borne by the child or the parents to obtain elementary education. The government will provide schooling free-of-cost until a child's elementary education is completed.

Traditionally, education provisioning comes under the purview of the states. Introduction of the RTE Act has made state and local bodies accountable for the implementation. Right from the beginning, the states have been clamouring that these bodies do not have the financial capacity to implement all the schools needed for universal education and without the assistance of the central government, RTE cannot be implemented.

To cover the additional burden, the proposal is to support the same with a 65:35 funds sharing ratio between the centre and the states.

This article makes an attempt to assess the impact consequent to implementation of RTE on the fiscal situation of the states. The 13th Finance Commission has already laid down some guidelines and a fiscal path for the states. As it will become clear from the subsequent analysis, implementing the RTE with a blanket single centre-state sharing pattern proves not only harsh on the states with already weak finances but is also economically not feasible.

The article first attempts to justify differential treatment of states on the basis of the fiscal condition and shows that with the present sharing pattern, many of the states would not be in a position to be on the fiscal path as per the requirements of the 13th Finance Commission recommendations. As a result of which the states would in fact be penalised by the 13th Finance Commission in terms of lesser grants-in-aid in future years.

The article next suggests a simple procedure to explore a differential proportion of sharing of burden among states. It categorizes the states into two groups, one which are weaker in terms of the present debt situation and the other comprising of those placed in a relatively better fiscal situation. The model is a simple re-distribution model whereby the centre's allocation from the stronger group is transferred to the weaker group, thereby obviating the need for the centre to spend more funds than it has already committed to spend under the RTE.

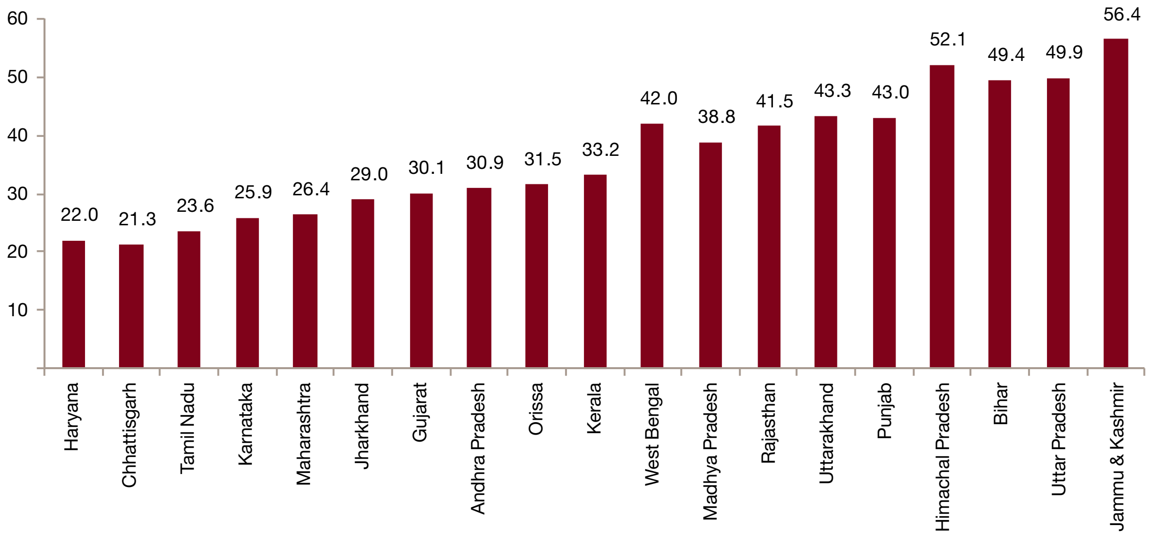
The model is, of course, a suggestive one and the centre can come up with other models after undertaking a more comprehensive analysis. But the basic contention of the paper remains: *'a blanket uniform sharing pattern is harsh on some states which are already in a tight fiscal situation'.*

However, it needs to be cautioned that this differential treatment of the states aligned to their respective fiscal situation lends them an incentive to under perform just to garner greater share from the centre. Hence, a proper "carrot and stick" incentive mechanism would need to be developed so that under-performance can be monitored and subsequently penalised.

Suggested Fiscal Path of States by the 13th Finance Commission

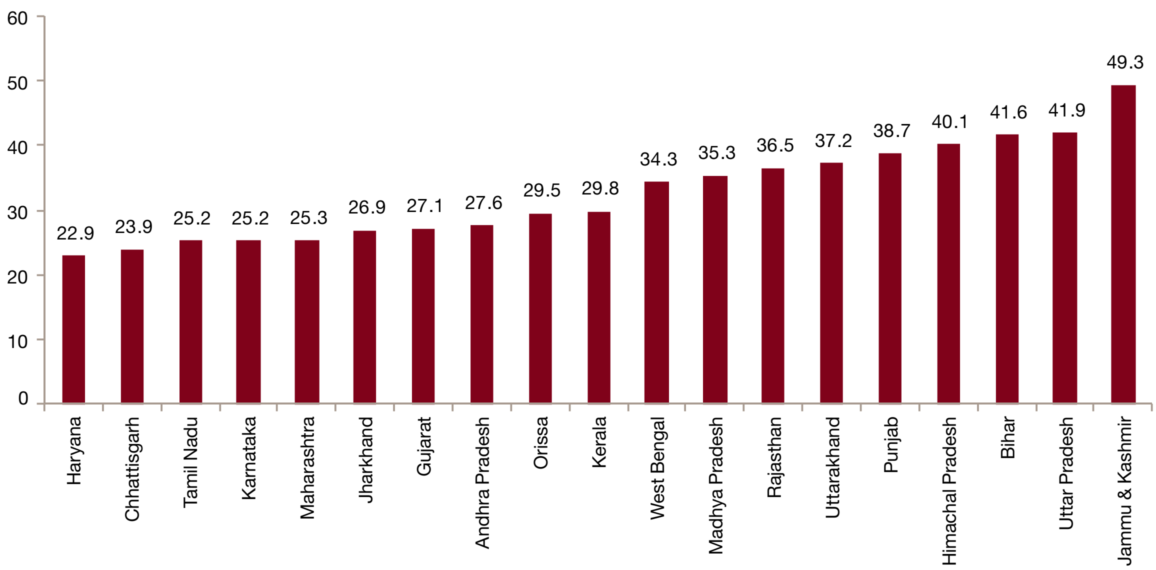
The following two graphs present a comparative analysis of the outstanding debt situations in different states in 2009-10 and in 2014-15. This is the de-facto debt path a state should maintain if the guidelines provided by the 13th Finance Commission are to be followed.

Figure 1: Outstanding Debt as % of GSDP in 2009-10



Source: 13th Finance Commission

Figure 2: Outstanding Debt as a % of GSDP in 2014-15



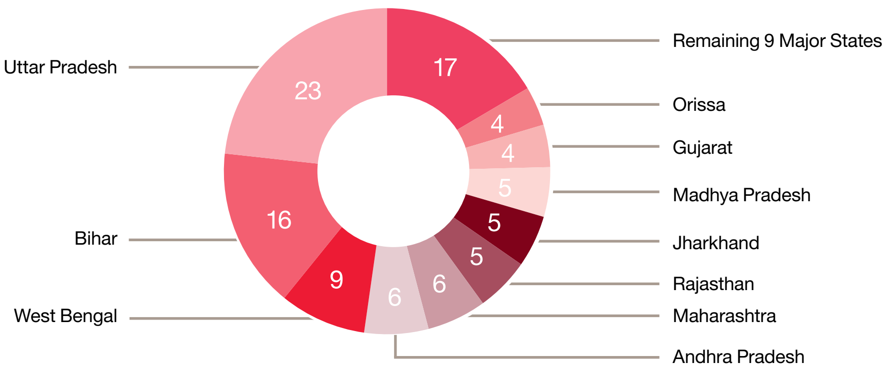
Source: 13th Finance Commission

Requirement under RTE

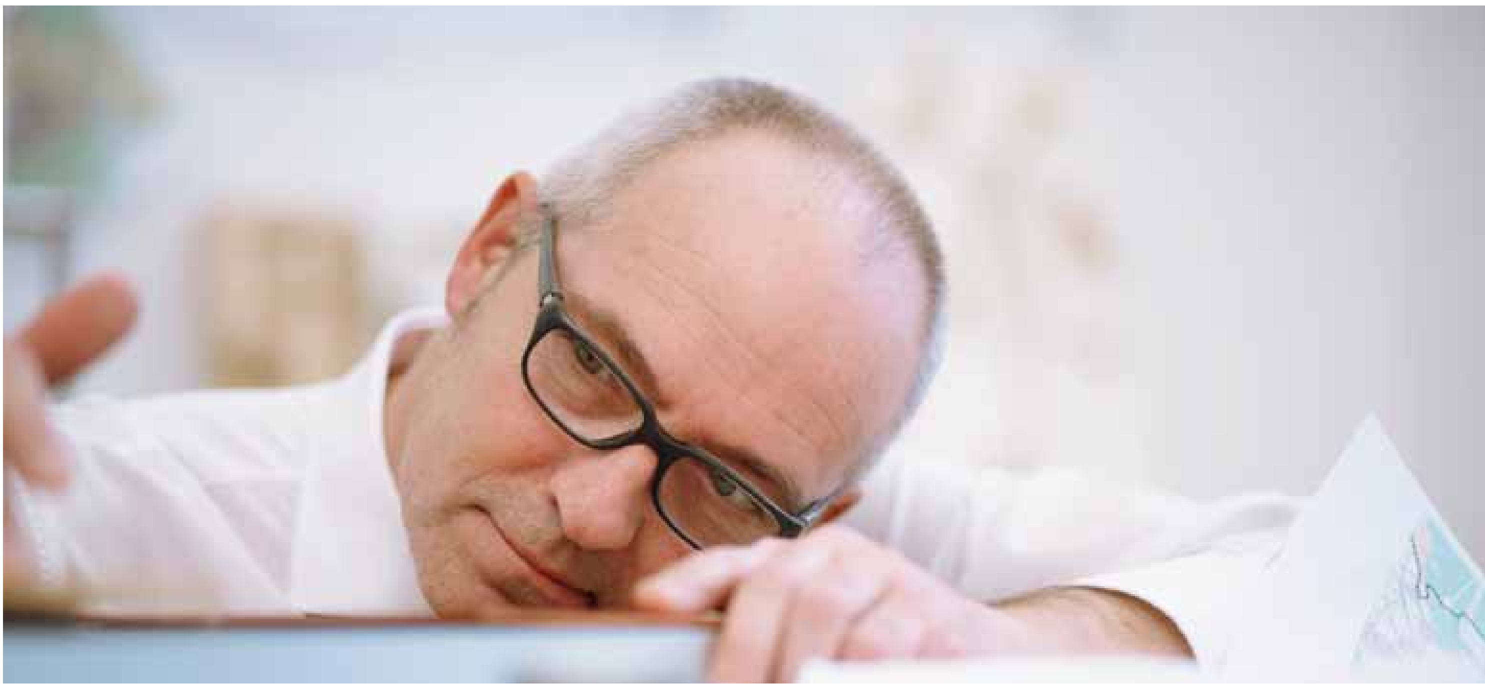
Figure 3 gives the state-wise percentage of current expenditure requirement for implementation of RTE till 2014-15 as computed by the Anil Bordia Committee (Published in May 2010). The Committee was set up to conduct a study to harmonize the Sarvya Sikhsha Abhiyan (SSA) vision, strategies and norms with the RTE mandate. This study covers 19 major states only, excluding the North-Eastern states due to their special status demanding separate attention.

It can be seen that states like Uttar Pradesh, Bihar, West Bengal, Andhra Pradesh and Maharashtra would be required to undertake much higher expenditure to fulfil the RTE obligations.

Figure 3: State-wise percentage of current expenditure requirement for implementation of RTE till 2014-15



Source: Anil Bordia Committee Report (May 2010)



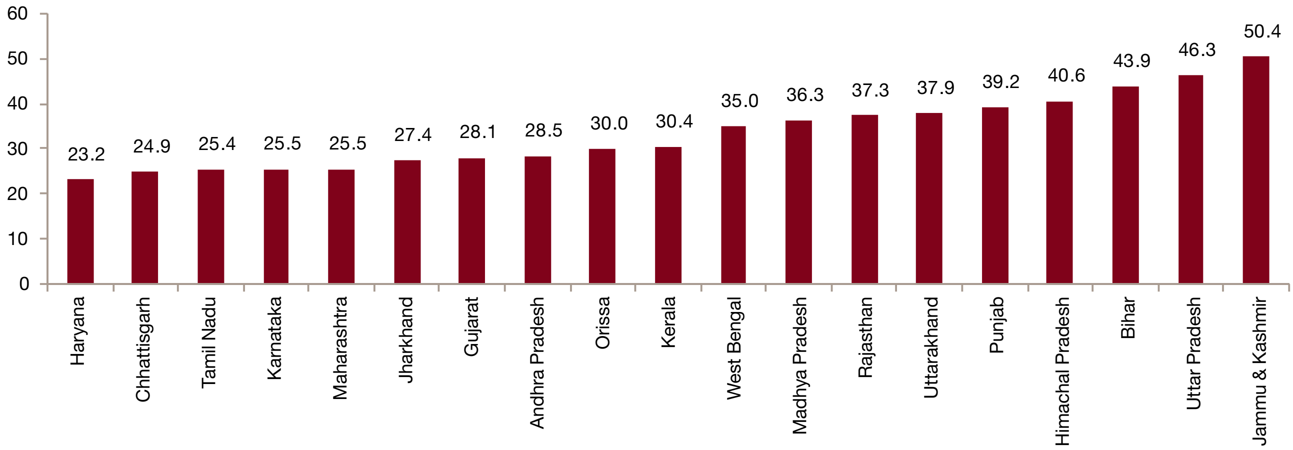
Gap from the approved level

Integrating the actual fiscal condition of the state with the additional burden of implementing RTE with the existing centre's share of 65% gives the actual outstanding debt of the states after implementation of RTE. Figure 4 presents the integrated debt as a % of GSDP for the states.

The actual percentage point deviation from the cap on the debt/GSDP ratio estimated by the 13th Finance Commission indicates the severity of the issue. This is presented in Figure 5.

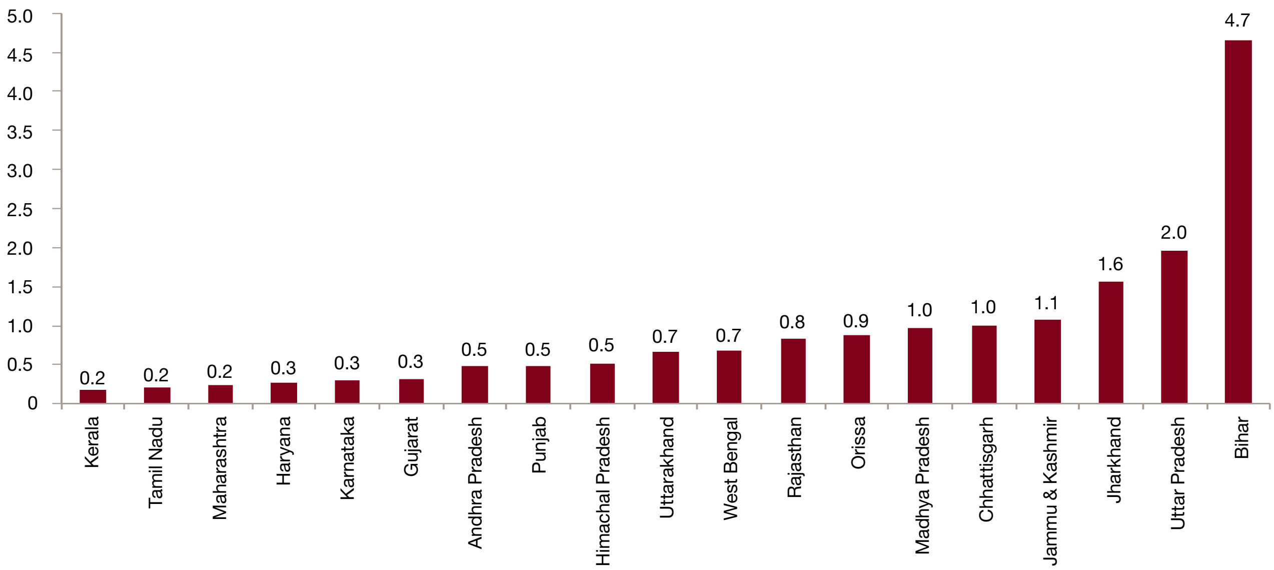
While Bihar may be considered as an outlier, however, situations of other states does not show a favourable position either and there is a clear disparity amongst states. This puts forward the case for differential treatment of states in terms of the share of allocation for implementation of the RTE Act.

Figure 4: Outstanding Debt post RTE implementation (as a percentage of GSDP) in 2014-15



Source: Compiled from the data from 13th Finance Commission and Anil Bordia Committee

Figure 5: % point deviation from the approved level of outstanding debt in 2014-15



Source: Compiled from the data from 13th Finance Commission and Anil Bordia Committee

Suggested Re-Distribution Model

With the need for differential treatment of states being established, a **"re-distribution model"** is being suggested taking into consideration the percentage point deviation from the level as suggested by the 13th Finance Commission and accordingly generate differential sharing ratio between the centre and the states.

The redistribution can be arrived at by the following steps:

Step 1: Classification of states into 2 groups

Without any loss of generality, we **assume** that only half of the states are in need of additional central assistance over and above 65%. This enables us to categorize all the states into two groups:

- **General Group:** States that do not need additional allocation from the centre. It is assumed that all the states in the **"General Group"** would be able to contribute 50% of the financial requirement under RTE.
- **Special Group:** States that need additional Central allocation over and above the planned 65%.

This assumption only means that states falling under **"General Group"** are relatively better off than the states under **"Special Group".** This categorization is done purely on the basis of percentage point deviation from the approved level as per 13th Finance Commission of outstanding debt in 2014-15.

Table 1: Categorizing States

General Group	Special Group
Andhra Pradesh	Bihar
Gujarat	Chhattisgarh
Haryana	Jammu & Kashmir
Himachal Pradesh	Jharkhand
Karnataka	Madhya Pradesh
Kerala	Orissa
Maharashtra	Rajasthan
Punjab	Uttar Pradesh
Tamil Nadu	West Bengal
Uttarakhand	

Step 2: Pooling of Additional Resources

- 15% of the requirement of each state in the **"General Group"**, already committed by the centre can be **"pooled"** and can be re-distributed among the states in the **"Special Group"**. Table 2 shows the calculations for arriving at the **"pooled"** allocation and Table 3 summarizes the amount **"pooled"** by the proposed strategy.

Table 2: Calculation for arriving at the "pooled" allocation

Group	States	Minimum Committed centre's Share	Total Requirement under RTE (Rs. in Crore)	Minimum Committed centre's Allocation = (3) * (4) (Rs. in Crore)
1	2	3	4	5
Special Group @ 65% of Total Requirements under RTE	Bihar	65%	26,600	17,290.00
	Chhattisgarh	65%	4,664	3,031.60
	Jammu & Kashmir	65%	2,295	1,491.75
	Jharkhand	65%	8,613	5,598.45
	Madhya Pradesh	65%	8,231	5,350.15
	Orissa	65%	6,504	4,227.60
	Rajasthan	65%	8,931	5,805.15
	Uttar Pradesh	65%	38,909	25,290.85
	West Bengal	65%	14,342	9,322.30
General Group @ 50% of Total Requirements under RTE	Andhra Pradesh	50%	10,621	5,310.50
	Gujarat	50%	7,035	3,517.50
	Haryana	50%	2,712	1,356.00
	Himachal Pradesh	50%	1,184	592.00
	Karnataka	50%	5,298	2,649.00
	Kerala	50%	2,183	1,091.50
	Maharashtra	50%	9,852	4,926.00
	Punjab	50%	3,557	1,778.50
	Tamil Nadu	50%	4,249	2,124.50
	Uttarakhand	50%	1,455	727.50
Total				**101,480.85**

Table 3: Financial Allocation of Centre: Existing vs. Post Re-Distribution

Existing	Post Re-Distribution	
Total Centre's Contribution @65%	Minimum Committed Centre's Contribution @50% for General Group @65% for Special Group	Total Pooled amount to be Re-Distributed
	101,480.85	*7,221.90*
108,702.75	**108,702.75**	

(Rs. in Crore)

Step 3: Allocation amongst the Special Group

As discussed earlier, the percentage point deviation from the approved level of outstanding debt is a good indicator of the severity of the problem a state faces in terms of the outstanding debt. We take this as an indicator to rank the states in decreasing order.

Table 4: Ranking of "Special Group" States according to the percentage point deviation from the approved level

Rank	States	% point deviation from the approved level
1	Bihar	6.0
2	Uttar Pradesh	2.5
3	Jharkhand	2.0
4	Jammu & Kashmir	1.4
5	Chhattisgarh	1.3
6	Madhya Pradesh	1.3
7	Orissa	1.1
8	Rajasthan	1.1
9	West Bengal	0.9

A proportion is calculated taking into account the deviation of the **"severity indicator"** from the lowest severely affected states in the **"Special Group"**. As observed in Table 3 this lowest value turns out to be 0.9. The **"pooled"** amount of Rs. 7,221.90 crore from reducing the centre's contribution by 15% to the **"General Group"** is distributed amongst the states in the **"Special Group"** in that proportion.

Table 5: Distribution of Additional Centre's Funds over and above 65% for "Special Group"

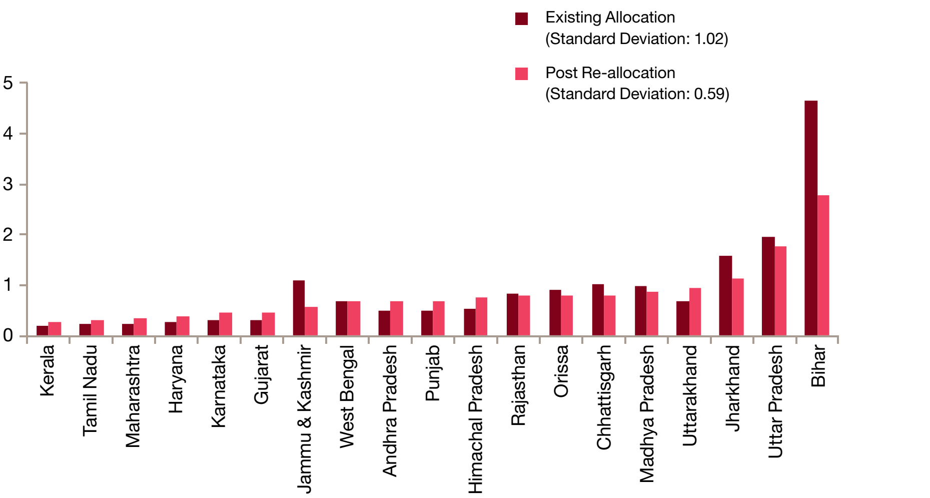
Rank	States	Proportion	Additional Amount from Centre (Rs. in Crore)
1	Bihar	52.46%	3,788.34
2	Uttar Pradesh	16.99%	1,226.89
3	Jharkhand	11.80%	852.41
4	Jammu & Kashmir	5.38%	388.63
5	Chhattisgarh	4.32%	312.31
6	Madhya Pradesh	4.05%	292.52
7	Orissa	2.83%	204.04
8	Rajasthan	2.05%	148.16
9	West Bengal	0.12%	8.60
	Total	**100.00%**	**7,221.90**

Comparison of Existing situation and Post Re-allocation situation

The proposed model is constructed in such a manner that it would appear that the states performing well in terms of their debt structure would lose in the bargain. However, given the fact that the federal structure of our country is envisioned with the objective that each state should be self sufficient in managing their affairs on their own and that the role of the centre is to provide a guiding hand so that equity is achieved and all states seek to converge to a uniform standard of living. Hence, if a state is prosperous, then it is all the more reason to take matters in their own hand and with as little external assistance from centre as possible.

Standard Deviation is a very handy indicator to compare situations before and after a re-distribution allocation. It is found that after the re-allocation the Standard Deviation has fallen from 1.02 to 0.59. This implies that the Post re-allocation situation is far superior in terms of variability across states. If the achievement of equity is linked with a more uniform pattern across states, then the re-allocation model presented above surely is a more equitable distribution.

Figure 6: % point deviation from the approved level of outstanding debt in 2014-15 (Post Reallocation)



Conclusion

It is a very thin line that any state government has to tread on balancing the objective of equity in terms of one of the most fundamental human need of proper education and the harsh reality of current financial situation.

A sound system, more attuned to realistic scenario of fiscal condition should be at place instead of a blanket all round centre-state sharing pattern. But this differential centre-state sharing pattern creates an incentive for states to underperform in terms of worse debt situation in lieu of higher grants. If a state gets a higher share of centre's assistance just by having a greater debt problem, no state would want to improve its debt status and the states would "compete" with each other, each trying to receive as much centre's allocation as possible.

We can address this by incorporating a "Carrot and Stick" mechanism into the system. A system should be in place such that if the state underperforms even with generous grants from centre it would be penalised in the following year. Linking the severity of the penalty to the grant received in the previous year would correct for any negative incentive a state might have to underperform.

One of the good practices that the centre and states could explore is the currently popular **debt-for-education swap**. Debt-for-education swaps can be defined as the cancellation of external debt in exchange for the debtor government's commitment to mobilise domestic resources (in local currency) for education spending. The concept of debt-for-education swaps belongs to a broader category of so-called debt-for-development swaps, arrangements which are designed to divert public resources from debt service to agreed upon development oriented spending.

In the end, we would like to maintain that while the model suggested above is only a suggestive one, it is open to further refining with more detailed analysis of available data incorporating various other socio-economic parameters. The underlying intention of this article is only to highlight the need to adopt a differential sharing pattern model more attuned to the actual fiscal condition of the state.

Pick of the Quarter

Sharing a Viewpoint

Revising Expenditure Classification System of Indian Government Budget Accounts

The budgetary classification system generates meaningful information on the functions of government transactions, their composition and impact. It is thus not only seen as an instrument of policy formulation, budget administration and accounting but also for the monitoring of the use of budgeted funds so that resources are used to implement the priorities of the government.

While classification of receipts is relatively simple as it involves identifying the sources of revenue, the activities generating the revenue and the organizations collecting it, classification of government expenditure, however, has to cover a wider need for providing information to support policy decisions on resource allocation, monitoring of performance of government programmes, ensuring accountability for budgetary compliance and evaluating the overall impact of policy decisions. According to these divergent information requirements for different classes of stakeholders, expenditures are classified into varied set of categories serving one objective or other of the government:

- '**Function**' for historical analysis and policy formulation (e.g. Classification of the Functions of Government, COFOG) which organizes government activities according to their purposes like education, social security, housing, etc.
- '**Program/Activity/Output**' for policy formulation and performance accountability
- '**Organization**' for accountability and budget ration
- '**Economic Category**' for statistics (e.g. Government Finance Statistics (GFS) Manual of IMF, 2001) and object/ line item, for compliance controls and economic analysis
- '**Funds**' to identify and trace source of financing
- **Any other category** needed to take into account special requirements.

Indian Context

As per the provision of the Constitution, the 'Annual Financial Statement' comprising annual receipts and expenditures prepared by the Government, commonly known as the Budget, shows the receipts and payments of the government under three heads: Consolidated Fund, Contingency Fund, and Public Accounts. The Consolidated Fund consists of Revenue and Capital Accounts, which are further disaggregated into sectors and sub-sectors, which broadly follows the major classification groups of COFOG.

- A **receipt budget** gives details of revenue and capital receipts, the trend of receipts over the years and, more importantly the details of external assistance received by the Government.
- The **expenditure budget** gives expenditure estimates in terms of revenue and capital under Plan and Non-plan heads in relation to each administrative unit, and describes expenditure in terms of major programmes.

However, it should be noted that under Articles 112 and 202 of the Constitution, where the annual financial statements of the union and state governments are prescribed, it is stated in clause (1) that this shall consist of "a statement of the **estimated receipts and expenditure** of the Government of India /state for that year". In case of the estimates of expenditure, however, it is stated, in clause (2), that such estimates "shall distinguish **'expenditure on revenue account' from 'other expenditure'**. This distinction between 'Revenue' and 'Other Expenditure' (the latter is generally interpreted as 'Capital Expenditure') is thus a constitutional requirement. **Plan and Non-plan expenditure does not find any mention in the Indian Constitution.**

However, since the introduction of the planning process in the country, budget heads have come to be divided under the **extra constitutional elements** of Plan and Non-plan expenditure and the distinction runs through all items of expenditure on revenue as well as capital accounts. The Planning Commission provides guidelines for the classification of expenditure into Plan and Non-Plan at the commencement of every Five Year Plan. While plan expenditure is defined as the expenditure on programmes/projects enlisted in the ongoing Five Year Plan, non plan expenditure is a generic term used to cover all expenditure not covered under the Five Year Plan.

Critical Review of Classification of Expenditure into Plan and Non-plan

There has been much debate about the utility of the classification of expenditure into Plan and Non-plan expenditure. It has been argued to the extent that this dichotomy between plan and non-plan expenditure is not only illogical but has also led to unnecessary developments bearing an adverse effect on the quality of public service in the following ways:

a. Focus on new schemes/ new projects/ new extensions within each sector over currently running schemes which alone qualify for being included in the plan, results in neglect of adequate debate on expenditure needed for maintenance of the existing capacity and service levels. This has led to an **ever increasing tendency to start new schemes** while neglecting the maintenance of existing capacity and service levels.

b. Often, non plan expenditure is perceived to be synonymous with non developmental expenditure and plan expenditure with developmental expenditure. Such **perception** around the distinction renders non-plan expenditure as wasteful and the need for it to be minimized. Routine bans on recruitment for non-plan posts, ostensibly imposed to conserve expenditure, consequently cause **serious problem for service delivery** in health, education, agriculture extension service and other sectors where the salary costs are high.

c. Besides, the current system of classification suffers from **inconsistencies related with the treatment of subsidies**. For instance, food and fertilizer subsidies are not included in plan expenditure but several other subsidies including the subsidy to socially desirable insurance schemes are included. Exclusion of large subsidy items from plan expenditure results in a fragmented view of resource allocation to various sectors and affects **resource prioritization** in the matter of determining the appropriate balance between subsidy levels and other expenditure to promote common developmental goals.

d. In addition, it can also be observed that the distinction between '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, the expenditure related to new projects/ programmes becomes 'Plan' expenditure during the period of a five year plan. If the projects/ programmes are completed within the five year plan period, then their maintenance is brought under 'non-plan' expenditure, during the next plan period. Again, the 'plan' expenditure, during a particular five year plan, could become 'non-plan' in the following plan, if the responsibility is shifted on to the state governments.

The classification of expenditure between "Plan" and "Non-plan" of schemes/ projects in government gives a distorted view of government's classification of expenditure. For instance, maintenance expenditure of a building is likely to suffer, whereas a plan scheme, even if it is not important, acquires a priority and urgency, out of its proportion, because it is a 'plan' item of expenditure. Again, it is possible to create posts under plan schemes, even if a ban exists on creation of posts. Thus, the classification of expenditure into 'Plan' and 'Non-Plan', sometimes, endows certain schemes with more than necessary legitimacy and thereby acts to distort one's view of public expenditure.

Apart from these issues, the kind of preparation process adopted in the case of plan expenditure is non-existent for non-plan expenditure as the latter is considered as committed expenditure in India. This practice further contributes in distorting the perception surrounding the non-plan expenditure.

Against this entire backdrop, the **solution** would be either to:

a. **refine** the existing classification of plan and non-plan expenditure and make it more robust by removing the above highlighted discrepancies which allows a scope for ineffective and inefficient utilization of public resources, or

b. to **completely do away** with this classification, and instead, devise an alternative mechanism that will perform the requisite functions in a rational and effective manner.

There is a general perception that option (b) is the preferred option and that **revenue & capital expenditure, without any distinction between plan and non-plan** should form the basis for budget classification.

Rationale for Classification of Expenditure into Revenue and Capital

The existing practice of classification between revenue and capital is based on the criteria laid down by the Team of Reforms in the Structure of Budget & Accounts (Mukherjee Committee) in its report of 1972, which is in line with the General Financial Rules 2005 and the Government Accounting Rules of the Government of India, 1999. The GFS Manual of IMF, 2001 which presents advanced standards for compilation and presentation of fiscal statistics, follows the principle of accrual accounting and its coverage of events is broader than the earlier version representing cash based transactions. The government accounts in India are kept on a cash basis. However, efforts are now being made to introduce the accrual system of accounting in government transactions.

The case for **classification of expenditure into the categories of revenue and capital** may be supported on the following grounds:

a. Distinction between revenue and capital ('other') expenditures is a constitutional requirement.

b. Focus on revenue and capital classification is not only in line with the international practices but is also expected to provide for expenditure which is currently classified as non-plan and is equally important for the achievement of developmental goals.
For instance, in case of Works Department, the present classification into plan and non plan provides only for discussion on new construction (capital expenditure) in the budget preparation stage at Planning Commission level as the construction expenditure is classified as plan expenditure. However, maintenance expenditure required post construction (revenue expenditure) which is critical for the efficient functioning of the asset is not discussed as part of plan deliberations at Planning Commission in the budget owing to its classification as non plan expenditure.

c. The categorization will also help in addressing the concern of excluding food and fertilizer subsidy from plan expenditure and thus may help in better resource prioritization in the matter of determining the appropriate balance between subsidy levels and other expenditure to promote common developmental goals.
A possible case for classifying such subsidies under the head of "expenditure on revenue account" exists.

Revision in the Expenditure Classification into Revenue and Capital: *Issues & Resolution*

There exists a scope for reviewing the existing norms for classification of expenditure between capital and revenue and suggest improvements with a view to reflecting a true and fair view of Government Budgeted Accounts. Some of the issues observed in the current classification system are:

a. Defence expenditure is treated as capital expenditure while it could be treated as 'expenditure on revenue account' based on the principles of national income accounting wherein defence expenditure is treated as consumption and not investment.

b. Capital expenditure as currently defined is not always and invariably tantamount to investment. For instance, recapitalization of PSEs, though classified as capital expenditure, is not, in most cases, investment. In fact a loss-making PSU may receive injections of equity to fund losses, in which case, what is conceptually a subsidy gets classified as a capital expenditure.

c. The treatment of Teachers' Salary in the education sector is treated as 'expenditure on revenue account' in the absence of creation of any tangible asset (as per GFR, 2005). However, should it be treated as capital expenditure on grounds of creation of human capital.

d. The Expert Group constituted by the Government of India in 2004 opined that one major area of concern has been the **transfers to the states** which are bunched together without assignment to any function or programme. The transfers are treated as revenue expenditures, irrespective of utilization of such funds for asset creation or not. The group recommended for better disclosures for such payments as capital transfers under revenue expenditure. The expert group also suggested a multidimensional classification system to harmonize budgetary, accounting and economic classification.

Conclusion

To recapitulate, budget preparation and discussion at Planning Commission level based on revenue and capital classification shall provide for the noted deficiencies of the plan and non-plan classification and would result in greater focus on total expenditure rather than plan expenditure which alone is not the only component of expenditure critical from the point of view of efficient public expenditure management.

A noteworthy point amidst such evaluation is that there is not only a need for switching from plan and non-plan classification to a more rational and effective classification of revenue and capital expenditure but also for **introducing a horizon of five years** into the process of presenting and discussing the budget based on the new classification. This will ensure sufficient allocation for critical components of operation and maintenance expenditure.

More importantly, with the existing ambiguities in the classification of expenditure into capital and revenue, it seriously undermines the effectiveness of the requirements of the 13th Finance commission of attaining zero revenue deficit as such targets can also be met through reengineering of the accounts.

PwC Updates

PwC's contribution towards the sector

Know our Work

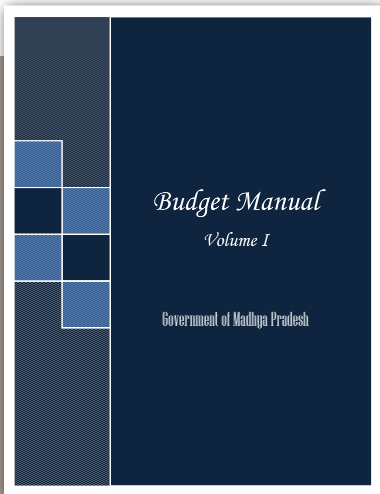
Budget Process Mapping/Budget Process Manual

Detailed Guide for Budgetary structure and process of State Governments

The Public Finance practice of PwC has undertaken budget process mapping and manual drafting for the Government of Madhya Pradesh and is currently preparing the same for Government of Rajasthan.

A Ready Reference

Various principles and rules guide the preparation of state budgets and various steps are involved in different phases of the budget cycle. Budget Process Mapping/Manual involves drafting of these principles, guidelines and steps in a systematic and sequential order for the guidance of estimating officers and departments of the Secretariat. The document serves as a ready reference for budget procedure, preparation and examination of the annual budget estimates and the subsequent control over expenditure to ensure that it is kept within the authorized grants or appropriations.



Field Anecdote

On landing in Colombo for an assignment, Ranen, Chaitanya and Suriya headed straight for meetings from the airport. By the time the meetings ended, the exhaustion from travel and work had set in, and the three decided to retire to their hotel rooms and rest for a while before re-assembling for dinner. At dinner time, Chaitanya and Ranen reached the decided venue at the agreed time but when Suriya did not turn up, they decided to check on him in his room. On knocking his door repeatedly, a very sleepy and exhausted Suriya opened the door and joined them immediately for dinner.

As the trio walked toward the restaurant in the hotel, Chaitanya and Ranen became engrossed in a discussion while Suriya, still not awake completely, lagged a couple of paces behind them. All of a sudden, Ranen and Chaitanya heard a loud splash behind them. On turning back, they could not locate Suriya anywhere around. As they frantically retraced their steps, they suddenly saw a human head pop out amidst leaves and flowers in the decorative pond that lay in the middle of the path. As they peered down at the pond in disbelief, they saw a dazed Suriya sitting on the floor of the pond with several tiny fishes and tadpoles hovering around him in obvious excitement.

Evidently, he had followed Ranen and Chaitanya blindly, not paying attention to where he was going and had failed to notice the pond. After taking a few seconds to comprehend the situation, Ranen and Chaitanya helped Suriya out of the water. Fortunately, he was unhurt though completely drenched in water that had questionable origins.

Know our People

Tapas Sanyal
Manager, Public Finance, GRID, PwC

Tapas is a Manager with PwC. He started his career as an Assistant Provident Fund Commissioner in Employees Provident Fund Organisation (EPFO), M/o Labour & Employment, Govt of India. He worked in EPFO for more than 7 years in different capacities viz. Assistant P.F Commissioner, Recovery Officer and Regional Provident Fund Commissioner. In the interim, he worked for three years in the field of Intellectual Property Rights (IPRs) in the Patent Office under the O/o Controller General of Patents, Designs, Trademarks and Geographical Indications as an Examiner of Patents & Designs. Tapas took a sabbatical and joined IIM Ahmedabad for a Post Graduate Programme in Public Management & Policy. Post IIMA and post his graduation from IIM joined PwC.

In EPFO, Tapas had rich experience in the provident fund, pensions and insurance administration. It involved amongst others, examination of applicability of the EPF & MP Act & Schemes for different establishments/classes of establishments, determination of dues through a quasi-judicial process and securing their compliance. Recovery of dues by attachment of movable and immovable properties, appointment of receivers, auction and sale of attached properties, arrest and detention of the defaulters in prison, appointment of valuers for carrying out valuation of assets, participation in deliberations before Board of Industrial & Financial Reconstruction(BIFR), Debt Recovery Tribunal(DRT),High Court, Official Liquidator for stressed asset management of sick companies, assisting in the restructuring of PSE's through joint implementation of VRS package for employees were all part of his job profile. Since EPFO also has a regulatory role, Tapas was involved in that aspect as well. He had carried out audit of private Provident Fund Trusts and had monitored the status of exempted establishments. He was also involved in vigilance administration for examination of cases related to frauds, corruption, embezzlement etc and had worked closely with anti corruption branch of Central Bureau of Investigation (CBI) and Central Vigilance Commission (CVC).

While working as an Examiner of Patents & Designs in the O/o Controller General of Patents, Designs, Trademarks and Geographical Indications, Tapas worked primarily in the field of pharmaceuticals, biotechnology, fermentation technology and other chemical applications as a Technical and Legal expert for testing the novelty, usefulness and industrial applicability of patent applications through prior art search of technical literature, examination of claims and recommending the grant or rejection of patents.

In PwC, he has been the Project Manager in Subprogram II of Assam Governance and Public Resource Management program. He is also the 'pension reforms expert' for the assignment and is currently engaged in helping Government of Assam in the rollout of the New Pension Scheme for its employees. In addition, he is engaged in the revision of Rules and regulations of the Govt of Madhya Pradesh under the DfID supported Long Term Consultancy for Strengthening Performance Management in Government (SPMG) project.

A keen sports enthusiast, Tapas had played table tennis at a competitive level and had represented the University at national level meet. An alumnus of Nehru Institute of Mountaineering, Uttarkashi, he had participated in two major expeditions as climbing member [Mt Papsura (6451 mt), 2005- status: unsuccessful] and Mt Kamet [(7756 mt-3rd highest peak in India) 2006- status: successful]. He is also an active member of the Himalayan Club.

Public Finance Practice

The Public Finance Practice of Government Reforms and Infrastructure Development (GRID) SBU of PwC in India has been closely working with clients in public sector and at all levels of Government as well as key donors such as DfID, JBIC, World Bank and ADB.

A large dedicated team of full time professionals and associates provide services in areas that include public expenditure management, revenue administration, budgetary policy development, financial restructuring, performance improvement, institutional strengthening & capacity building, accounting & financial management systems, human resource development.

PwC has been providing advisory services to Governments, Multilateral and Private Sector Clients in the area of public finance. The work has broadly included, budget reform, revenue augmentation strategies, automation/computerization, and debt management. Most of these projects included training and capacity building of the Government counterparts working with PF team on the specific modules. In addition, the team has gained a lot of traction in the PEFA/FRA area with many assignments across South Asia.

Field Visit under the Fiduciary Risk Assessment for Rastriya Madhyamik Shiksha Abhiyan (RMSA)

About PwC

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Complementing our depth of industry expertise and breadth of skills is our sound knowledge of the local business environment in India. We are committed to working with our clients in India and beyond to deliver the solutions that help them take on the challenges of the ever-changing business environment.

PwC has offices in Ahmedabad, Bangalore, Bhubaneshwar, Chennai, Delhi NCR, Hyderabad, Kolkata, Mumbai and Pune.

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