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# UNIT 11 PERFORMANCE BUDGETING

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## Structure

- 11.0 Objectives
- 11.1 Introduction
- 11.2 Performance Budgeting : Concept and Objectives
- 11.3 Steps in Performance Budgeting
- 11.4 Performance Budgeting System in India
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## 11.0 OBJECTIVES

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After studying this unit, you should be able to:

- explain the concept and objectives of performance budgeting
- describe the steps in performance budgeting
- discuss the performance budgeting system in India; and
- evaluate the performance budgeting system.

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## 11.1 INTRODUCTION

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In a planned economy, it is logical to think in terms of budgeting both as the nearest link in a well-integrated system of planning, programming and budgeting and as a tool of management. It provides a system of information for decision-making, coordination, evaluation and control to the appropriate levels of the organisation. During recent years, there has been a significant increase in public expenditure. Government's involvement in the stabilisation of the economy, equitable distribution of wealth, stimulating forces leading to economic growth and increase in the price levels are some of the factors that have contributed to the increasing public expenditures.

The increasing public expenditures which brought with them a good deal of complexity, led to two significant questions:

- i) how to control and regulate the increasing public expenditures; and
- ii) how to introduce efficiency into the public expenditures.

In this unit an attempt has been made to explain the concept of performance budgeting and its genesis in Indian administration. A critical review of the system has also been done in the unit.

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## 11.2 PERFORMANCE BUDGETING : CONCEPT AND OBJECTIVES

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As we have discussed in Unit 2 of Block 1 of this course, the financial system of our country during the British period was characterised by high degree of centralisation, adherence to rigid financial rules and procedures, integration of accounts and audit etc. After independence, attempts have been made to make 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 make the budget an efficient tool of plan implementation. The result has been the introduction of the performance budgeting system in the government. We shall discuss in detail about the evolution of performance budgeting system in India in Section 11.4 of this unit.

Performance budgeting is generally understood as a system of presentation of public expenditure in terms of functions, programmes, performance units, viz. activities/projects, etc., reflecting primarily, the governmental output and its cost. It is essentially a process which brings out the total governmental operations through a classification by functions, programmes and activities. Through suitable narrative statements and workload data that form an integral part of the presentation, it indicates 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 resources 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 important than the object of expenditure under performance budgeting. Thus performance budgeting is a programme of action for any given year with specific indicators regarding tasks, the means of achieving them and the cost of achieving them. It tries to define the physical and financial aspects of each programme and activity and thereby establish the relationship between output and inputs. Performance budgeting has to operate within the framework of clearly defined objectives which are to be achieved through successful implementation of various programmes and activities undertaken by the concerned agency. Performance budgeting, therefore, involves the development of more refined management tools, such as work measurement, performance standards, unit costs, etc.

**Objectives:** Performance budgeting seeks to:

- i) correlate the physical and financial aspects of programmes and activities;
- ii) improve budget formulation, review and decision-making at all levels of management in the government machinery;
- iii) facilitate better appreciation and review by the legislature;
- iv) make possible more effective performance audit;
- v) measure progress towards long-term objectives as envisaged in the plan; and
- vi) bring annual budgets and developmental plans together through a common language.

#### **Components of Performance Budget**

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

- i) a programme and activity classification that represents the range of work of each organisation;
- ii) a framework of specified objectives for each programme;
- iii) a stipulation of the targets of work or achievement; and
- iv) suitable workload factors, productivity and performance ratios that justify financial requirements of each programme.

#### **Formulation of Performance Budget**

Each performance budget will in the first instance indicate the organisational structure and the broad objectives that govern the approaches and work of the administrative agency. This is followed by a Financial Requirements Table. This Table is the most important part of the performance budget and has three basic elements:

- a programme and activity classification indicating the range of work of the agency in meaningful categories
- object-wise classification showing the same amount distributed among the different objects of expenditure such as establishment charges; and
- sources of financing indicating the budgetary and account heads under which the funds are being provided in the budget.

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### **11.3 STEPS IN PERFORMANCE BUDGETING**

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

- i) Establishing a meaningful classification of public expenditure in terms of functions,

- ii) the establishment, improvement and extension of activity schedules for all measurable activities of the government;
- iii) the establishment of work output, employee utilisation, standard or unit costs by objective methods, i.e. bringing the system of accounting and financial management into accord with the classification; and
- iv) the creation of related cost and performance recording and reporting system.

The important requirement for performance budgeting is a programme of action for any given year with specific indications regarding the tasks, the means of achieving them and the costs of achieving them. This is important even in traditional budgeting process. The distinction, however, is that under performance budgeting the organisations are compelled to think of their future activities not merely in terms of financial plans but in terms 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 process and budgeting is a doing process. Since the physical and financial aspects go together and the programme structure is expected to be the same, performance budgeting facilitates the functional integration of the thinking and doing process.

The formulation of programmes for achieving the organisational goals is an important task in the budgetary process. A programme is a segment of an important function and represents a homogeneous type 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 resources 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 many activities which are shown in the respective budgets. For example immunization programme is a programme under the function 'health'. As each programme has many activities, provision for storage of vaccines could be an activity under the programme.

The real commencing point in the budgetary process is allocation of resources. In the conventional system primary emphasis is laid on the previous level of allocations and spendings and no emphasis is laid on its performance in terms of its objectives and the programme of action that it has set out for itself for the next year. Under performance budgeting the primary agency prepares the budget, submits its requirements as per programme classification. It indicates its past activities, their costs, the activities to be taken up during the next year, the results expected and the pattern of assignment of responsibilities. The very basis of the performance budgeting is commitment to achievement and the awareness of accountability. The budget so prepared is reviewed at higher level and resources are allocated keeping in view the priorities of the proposal. Some times due to financial constraints resources may not be available in full and a cut has to be imposed. However, 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 achievement.

Resource allocation is followed by budget execution. Budget execution must ensure achievement of objectives and for that the following budgetary and managerial considerations must be kept in view:

- i) Communication of the grants to the various subordinate agencies well in time
- ii) Ensuring the initiation of action for implementing the schemes provided for in the budget
- iii) Overseeing the regular flow of expenditures
- iv) Prevention of cost over-runs; and
- v) Time phased plan for expenditure and work.

The final stage in the performance budgeting process is appraisal and evaluation.

Under the existing system evaluation of the physical achievements in certain sectors is being undertaken by the Programme Evaluation Organisation. Under performance budgeting, each programme would lend itself to an evaluation by the agency concerned, even before it is undertaken by an outside organisation. The important aspect 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.

### Check Your Progress 1

**Note:** i) Use the space given below for your answers.  
ii) Check your answers with those given at the end of the unit.

1) Explain the concept of performance budgeting.

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2) List the objectives of performance budgeting.

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3) Describe the budgetary process involved in performance budgeting.

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## 11.4 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 established between financial outlays and physical targets. The first study regarding the relevance of performance budgeting to our institutional set-up and needs was made by Dean Appleby in 1953. At that stage, however, the system of performance budgeting was still incipient in the federal government and Dean Appleby was not very certain 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 included in the budget, especially in the case of large scale developmental activities. The Performance Budgeting should be the goal which should be reached gradually and by 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 regarding 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. However due to operational problems, 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 fulfilment." As a part of the implementation of this suggestion, the planning commission formed a Performance Budgeting unit in the Committee on Plan Projects in 1965. In order to identify the benefits this unit conducted 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 established by 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 by 1970-71. In view of this, the Union Finance Ministry submitted a document known 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.

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## 11.5 PERFORMANCE BUDGETING SYSTEM — A CRITICAL EVALUATION

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The government accepted performance budgeting and initiated the process of change, gradually and cautiously, almost 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, however, been very slow in most of them, it is, therefore, necessary to take stock of the gains and limitations relating to performance budgeting. This shall help in consolidating gains and tackling problems and making performance budget an effective tool of internal financial management at all levels of government.

Performance Budgeting improves legislative review by presenting a comprehensive view of the various 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 process of planning and budgeting.

Performance Budgeting helps to improve public relations by 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 process and evoke meaningful participation of the citizens in the implementation of the tasks set out in the budget.

In any organisation decision-making with regard to allocation of resources, 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 by decentralised accounting and systematic reporting could provide such informational support.

Functional classification (about which we have discussed in Unit 7 of Block 2) facilitates integration of the process 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 aspects. The advantages of performance budgeting in such a situation is that it brings the financial and physical aspects together right from the beginning of the proposal to the final stage of the scheme.

In brief, performance budgeting provides for more effective controls, makes legislative control more meaningful, helps to gear the process of decentralisation of authority in conformity with responsibility and improves public relations.

Having considered the different aspects of the technique it shall be in the fitness of things to briefly enlist some of its limitations as well. Important among these are as under:

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

**Check Your Progress 2**

**Note:** i) Use the space given below for your answers.  
ii) Check your answers with those given at the end of the unit.

- 1) Trace the events which led to the adoption of performance budgeting in India.

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- 2) Critically evaluate the suitability of performance budgeting.

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**11.6 LET US SUM UP**

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Performance budgeting is a system of presenting public expenditure in terms of functions and programmes reflecting the government output and its cost. It is designed to serve the purposes of long range planning. If it is to be of operational significance, it must be built from operating levels of responsibility and summarised suitably for higher level of management. It must be remembered that performance budgeting is a tool. Whether it is manageable or unwieldy depends largely on the skill of the toolmaker. Efficacy of its application depends on the skill, imagination, energy and strength of purpose of the user. All it can provide is meaningful basis for administrative planning, executive coordination, legislative scrutiny and administrative accountability at all levels of government.

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**11.7 KEY WORDS**

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**Cost Benefit Analysis:** A systematic comparison between the cost of carrying out any service or activity and the value or the benefit of that service or activity. An attempt is made to quantify as far as possible all costs and benefits arising from that activity.

**Financial Requirements Table:** It refers to the table indicating programme and object-wise classification of activities indicating budgetary and account-heads under which the funds are provided.

**Performance Budget:** An output-oriented budget emphasising the accomplishment rather than means to accomplishment.

**Performance Audit:** Assessment of the performance of an organisation with a view to know that the results achieved have been commensurate with the expenditure of resources.

**Work Measurement:** It is a method of establishing the time taken by a qualified worker to carry out a specified job at a defined level of performance.

## 11.8 REFERENCES

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United Nations, 1966. *A Manual for Programme and Performance Budgeting*, U.N. Publications : New York.

## 11.9 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

### Check Your Progress 1

1) Your answer should include the following points:

- It is a system of presentation of public expenditure in terms of functions, programmes and performance units.
- Output-oriented budget information.
- Accomplishment based.

2) Your answer should include the following points:

- Correlating the physical and financial aspects of programmes and activities.
- Improves budget formulation, review and decision-making at all levels of management in the government machinery.
- Facilitates better appreciation and review by the legislature.
- Makes possible more effective performance audit.
- Measures progress towards long-term objectives as envisaged in the plan; and
- Brings close annual budgets and developmental plans.

3) Your answer should include the following points:

- Formulation of programmes and establishment of meaningful classification in terms of functions, sub-functions, programmes, sub-programmes, activities, etc.
- Allocation of resources.
- Budget Execution.
- Appraisal and Evaluation.

### Check Your Progress 2

1) Your answer should include the following points:

- Inadequacy of budgeting and control system in the early era of planning.
- Suggestions of Estimates Committee of Lok Sabha in its 20th report.

- Setting up of Administrative Reforms Commission and its recommendations.
- Implementation of performance budgeting in India.

2) Your answer should include the following points:

- Improves legislative review.
- Meaningful participation of the masses.
- Provides informational support.
- Integration of process of planning, programming and budgeting.
- Some of the limitations of performance budgeting include:
  - Classification of work difficult and broad.
  - No qualitative evaluation.
  - Dependent upon support from other techniques.



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# UNIT 12 ZERO BASE BUDGETING

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## Structure

- 12.0 Objectives
- 12.1 Introduction
- 12.2 Concept and Meaning of Zero Base Budgeting
- 12.3 Zero Base Budgeting and Traditional Budgeting: A Comparison
- 12.4 Genesis of Zero Base Budgeting
- 12.5 Steps/Elements of Zero Base Budgeting
- 12.6 Introduction of Zero Base Budgeting in India
- 12.7 Implementation of Zero Base Budgeting — Benefits and Problems
- 12.8 Let Us Sum Up
- 12.9 Key Words
- 12.10 References
- 12.11 Answers to Check Your Progress Exercises

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## 12.0 OBJECTIVES

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After studying this unit, you should be able to:

- explain the concept and meaning of zero base budgeting
- distinguish zero base budgeting from traditional budgeting
- trace the developments which necessitated the introduction of zero base budgeting
- describe the process involved in implementation of zero base budgeting; and
- discuss the problems and benefits in implementation of zero base budgeting system.

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## 12.1 INTRODUCTION

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India has been passing through a tight financial position. The budgetary deficit over the years has been increasing and as a result strict financial control became an urgency. The Government has taken a number of steps to reduce the budgetary deficit through control of expenditure. However, it is a well-known fact that financial management can be toned up through budgetary reforms on the lines of Zero Base Budgeting. Zero Base Budgeting (ZBB) is a control technique which requires that an organisation while preparing its budget should not take earlier year's expenditure for granted but should start afresh. This concept implies that a complete re-examination of the ongoing programmes and activities should be carried out to assess their continued utility.

In this unit an attempt has been made to explain the concept of Zero Base Budgeting, its objectives, historical background and the process followed for its implementation. It also discusses the benefits and problems arising from the implementation of zero base budgeting.

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## 12.2 CONCEPT AND MEANING OF ZERO BASE BUDGETING

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Zero Base Budgeting is a management process that provides 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 must be justified in its entirety each time a new budget is formulated. It implies that, in defence of its budget request no department shall make reference to the level 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 process. It identifies alternative and efficient methods of utilising limited resources in the effective attainment of selected

benefits. It is a flexible management approach which provides a credible rationale for re-allocating resources by focusing on the systematic review and justification of the funding and performance levels 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 various alternative ways of achieving these objectives, selecting the best alternatives through cost-benefit and cost-effectiveness analysis, prioritisation of objectives and programmes, switching of resources from programmes with lower priority to those with higher priority and identification and elimination of programmes which have outlived their utility.”

Zero Base Budgeting, thus, is an operating, planning and budgeting process which requires each manager to justify entire 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 identified in decision packages (or programmes) that relate inputs (costs) with outputs (benefits), (ii) each one be evaluated by 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 levels 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. However, in zero base budgeting the idea is proposed to experience it year after year i.e. every time the budget for the next 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 must re-evaluate all activities to find out the level to which such activity should be funded, i.e. whether it should be eliminated or shall be funded at reduced level or increased level or similar level? It shall be determined by the priorities established by top management and by the availability of funds.

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### **12.3 ZERO BASE BUDGETING AND TRADITIONAL BUDGETING: A COMPARISON**

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Zero Base Budgeting is more or less a self-defining term. As we have discussed earlier, in zero base budgeting all expenditures are thoroughly analysed from zero base, such that the current expenditure levels 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 levels need to be investigated. Failure to investigate current expenditure regarding its necessity and effectiveness will lead to funding of activities for which no increase, or perhaps a decrease in spending is warranted.

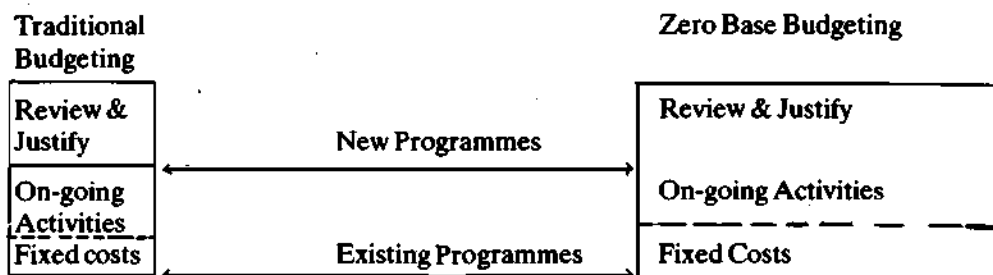
Traditional budgeting has not proved to be a suitable tool for shifting resources from low to high priority areas. It does not involve the same rigorous approach as zero base budgeting and does not answer the question as to whether we are getting value for the money being spent.

Zero Base Budgeting is a decision-oriented approach and focuses on old and new activities and connects short and long range goals by 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 level is extrapolated into next year,
- Some growth factor is added on account of inflation, increase in prices of raw material and wages etc.
- Spending level 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:



Thus ZBB helps managements to evaluate the claims on scarce resources in terms of organisation's objectives and to make trade-off's among current operations, development needs and profits, and allocate the financial and other scarce resources for the achievement of the objectives or goals of the organisation.

#### Check Your Progress I

- Note:** i) Use the space given below for your answers.  
ii) Check your answers with those given at the end of the unit.

- 1) Discuss the concept of ZBB highlighting its aims and objectives.

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- 2) Distinguish between ZBB and traditional budgeting.

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## 12.4 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 Defence 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 by 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.

This experiment however proved unsuccessful due to various reasons. The various agencies proceeded on the assumption that their programmes were necessary and formulated them accordingly. The new technique was taken as an additional exercise enhancing the volume of paper work, time and energy and as such it could not be

managed properly by the concerned agencies.

However, it was Peter Pyhrr who designed 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 by Arthur 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. Thus 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 several ways e.g. it will:

- Focus the budget process in a comprehensive analysis of objectives and needs.
- Combine planning and budgeting into a single process.
- Cause managers to evaluate in detail the cost-effectiveness of their operations.
- Expand management participation in planning and budgeting at all levels 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 process that provides 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 levels in the budget process.
- Justify the resource requirements 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 levels in an agency, objectives against which accomplishments can be identified and measured.
- Assess alternative methods of accomplishing the objectives.
- Analyse the probable effects of different budget amounts or performance levels on the achievement of objectives; and
- To provide a credible rationale for re-allocating resources, especially from old activities to new activities. Though the conversion from conventional budgeting to ZBB did pose some problems, yet the implementation process proceeded smoothly. Thus 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.

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## 12.5 STEPS/ELEMENTS OF ZERO BASE BUDGETING

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ZBB is a four step budgeting process which can be applied in a relatively simple way in any organisation. However, there are a number of conditions which must be fulfilled for a successful implementation of ZBB.

- There must be 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 must have the unqualified support and involvement of top management.
- ZBB must be tailored to the technical requirements of the organisation intending to implement it.
- A budget should be prepared for the organisation.
- The implementation of ZBB programme will be aided by a commitment to post-implementation review and maintenance of the programmes.

The basic four steps are:

- 1) Review of organisational structure, and identification of decision units and their objectives.
- 2) Analysing the decision units, working and evolving documented decision packages.
- 3) Reviewing and ranking the decision packages on the basis of chosen criteria.
- 4) Allocation of organisation resources 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 organisational structure and activities conducted. 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 intended to isolate key decision points in the organisation's hierarchy commencing with the lowest level and progressing to the top.

The identification of the organisational entities (decision units) which will prepare budget requests for the organisation are accomplished through selection by higher level 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 make significant decisions on the amount of spending and the scope, direction, or quality of work to be performed. A decision unit is a distinct segment of an organisation for which budget is prepared.

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

The identification helps in deciding the levels 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 difficult exercise. It is imperative that in the identification there should be a complete knowledge about the organisational structure, its management and objectives. Once the decision units have been identified, each of these must be analysed 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, (c) whether any of the tasks being performed be reduced or eliminated completely (d) the minimum staffing required to accomplish the normal functions of the decision units.

### **Step 2. Formulation and Development of Decision Package**

Top level management completes two functions in the zero base budgeting process before decision packages (budget requests) are prepared. It decides as to which level 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

first a "top-down" process before becoming a "bottom up" management process.

A decision package includes comprehensive justification for budget estimates of an activity. Such a justification is built up by 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 by 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 base budgeting in the Government of India" a decision package is a budget request which should contain the following:

- A description of the functions or activities of the decision unit.
- The goals and objectives of the various 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 rank it against other activities competing for the same or similar limited resources and (b) decide whether to approve or disapprove it.

One of the significant aspects of the decision packages is that it is used by a manager to define his or her objectives and responsibilities and how best to meet them at various levels 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	
Description of Activity	Personnel No.				
	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 next important step is to rank the decision packages. Ranking is the process of arranging the various service levels (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 process allows management to allocate scarce resources by concentrating on the following three key questions:

- 1) Where to spend the money first?
- 2) How much should be spent in pursuing these goals and objectives?
- 3) 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 huge numbers involved the ranking process takes place at a number of levels depending on the size, geographical dispersion, levels of management, volume of decision packages, unit managers, budget staff or by ranking committee.

#### Cut off level 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 several levels of effort could create a number of problems. 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 by:

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

All packages presented for funding generally would fall into three categories

- i) Those with higher priority and high probability of funding.
- ii) Those with marginal priority and which may be funded or not funded depending on the resources available; and
- iii) Those with low priority and low probability of funding.

The cut off level of funding is usually established arbitrarily as a percentage of current year budget or actual expenditure level or in absolute rupee value. It is important to note that cut off level has nothing to do with the ultimate allocation of resources. 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 and ranking	B <sub>1</sub>	B <sub>2</sub>	B <sub>3</sub>	B <sub>4</sub>	
Middle level consolidation	C <sub>1</sub>	C <sub>2</sub>	C <sub>3</sub>	C <sub>4</sub>	C <sub>5</sub>
Preliminary ranking by managers who developed it	D <sub>1</sub>	D <sub>2</sub>	D <sub>3</sub>	D <sub>4</sub>	D <sub>5</sub>

Each subordinate review level prepares a ranking sheet to submit to the next higher review level. 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 by the ranking manager who sends it to the next ranking manager. It serves the following purposes:

- 1) It identifies cumulative funding level which helps top management to know whether the total budget request has exceeded the total available resources or is still below it.
- 2) It allows top management to decide which package it wants to review in detail.
- 3) It provides a work sheet to top management to make funding decisions among several rankings readily, adjust the funding levels etc.

The ZBB can be adopted by any organisation willing to aggressively eliminate its budgetary deficit. But only managers intimately acquainted with the organisation culture can make it work effectively. Although the process is ideally suited for cost-effective planned growth, most managers probably will be initially interested in its enduring cost-reduction aspects and the capability it provides for responding flexibility to sudden shifts in an operating environment.

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## 12.6 INTRODUCTION OF ZERO BASE BUDGETING IN INDIA

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The concept of ZBB has been in use in Indian private industry since long. For example Britannia Industries Ltd. and Union Carbide have been using it since 1977-78 without calling it Zero base budgeting. However 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, several alternative steps were recommended to the government by 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 important 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 deficit financing than was envisaged in the plan document. Neither alternative was desirable and therefore the government, had launched a massive economy drive. On 10th July 1986, the Ministry of Finance issued a 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 formed.

The Finance Ministry had identified around 150 redundant and low priority schemes with the estimated outlays over Rs. 1000 Crore which the Ministry wanted to eliminate.

Among the State governments, Maharashtra has been implementing ZBB in 42 departments. The budget for 1987-88 reflected a saving of Rs. 50 crore. Several redundant and duplicative and low priority schemes have either been eliminated or merged.

Similarly Karnataka Government experimented with ZBB in Public Health and Agriculture Sections and also had plans to apply it to all 45 departments. Among 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.

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## 12.7 IMPLEMENTATION OF ZERO BASE BUDGETING – BENEFITS AND PROBLEMS

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The implementation of ZBB has certain benefits and some problems 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:

- i) Zero base budgeting examines all existing and new programmes and activities. It also makes the managers analyse their functions, establish priorities and rank them. This exercise helps in identifying inefficient or obsolete functions within the area of responsibility. In this way resources are allocated from low priority programmes to high priority programmes.
- ii) This system facilitates identification of duplication of efforts among organisational units. Such inefficient activities are eliminated and some other activities are merged.
- iii) All expenditures, under this system are critically reviewed and justified and all operations/activities are evaluated in greater detail in terms 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.
- iv) ZBB promotes the tendency to initiate studies and improvements during the period of operation as the persons at the helm of affairs know that the process would be exercised next year and their knowledge and training would enhance efficiency and cost-effectiveness.
- v) ZBB provides for quick budget adjustments during the year. If revenue falls short in this process, it offers the capability to quickly and rationally modify goals and expectations to correspond to a realistic and affordable plan of operations.
- vi) ZBB ensures greater participation of personnel in formulation and ranking processes. This helps in promoting level of job satisfaction and thus resulting in better control and operational efficiency in the organisation.
- vii) Zero base budgeting is a flexible tool that can be applied on a selective basis. It does not have to be applied throughout the entire organisation or even in all the service departments. Keeping in view the limitations of time, money and persons available to instal, operate and monitor it the management thus can select priority areas to which zero base budgeting may be applied.

The benefits of ZBB thus 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 resources rationally.
- It sharpens and quantifies objectives and formulates alternative methods of operations.
- It promotes involvement of line managers in budget formulation.

### Problems in Implementation

- i) **Management factors:** Whenever any cost control technique like zero base budgeting is adopted there is resistance from certain individuals and groups having interest in the organisation. Since goals, objectives and targets are achieved through the actions of responsible people whose behaviour makes the system work or fail, it is essential for the organisation to examine the effects of adoption of new techniques on the people and the effects of people on techniques. This is very important 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 important for the management to effectively manage its internal organisation before taking any step towards implementation of the zero base budgeting. Thus effective management of the organisation is the primary requisite in implementation of the programme.
- ii) ZBB is time consuming and is a more complicated process 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 levels to understand the system thoroughly there is need for proper communication system.
- iii) ZBB involves voluminous paper work. Each decision unit is supposed to prepare decision packages and give proper justification. In government departments,

where there are thousands of programmes and activities, the number of decision packages may run into several thousands. This is bound to create handling problems and confusion.

- iv) There is no standard formula for identifying the minimum level of funding. Generally minimum level of funding is identified on arbitrary basis which comes from top management as budget guidelines. But the viability of this procedure is questionable.
- v) The ranking of decision packages, particularly when the number of such packages is large, creates a big problem. The ranking may become an unwieldy process.
- vi) Zero base budgeting decision and the process of fixing priorities become a political nightmare. Conflict may arise on ranking as managers have a tendency to assign a higher priority, to their own projects.

Problems of ZBB can be summed up as:

- i) It challenges the past practices, performance, attitudes, of people.
- ii) It requires more time and effort.
- iii) Detailed costs and necessary information for decision packages often are not made available.
- iv) It increases paper work to unmanageable proportions.
- v) Ranking a large number of decision packages becomes an unwieldy process.
- vi) Identifying various levels of funding, particularly the minimum level is a difficult task.

### Check Your Progress 2

Note: i) Use the space given below for your answers.

ii) Check your answers with those given at the end of the unit.

- 1) Trace the evolution of zero base budgeting system in India.

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- 2) Describe the stages in the implementation of zero base budgeting.

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- 3) What are the benefits of this technique?

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## 12.8 LET US SUM UP

The ZBB is a technique which helps in achieving the goals of an organisation through better resource allocation. It is a system of helping managers at all levels to evaluate in

detail the cost-effectiveness of their operations and specific activities. It permits the executives to better establish their priorities and allocate scarce resources. Under this system, new expenditure proposals are to compete on the same footing with the ongoing expenditure based on their respective merits so as to claim a share of the available resources. In India ZBB was formally introduced in 1986 but so far it has failed to take off. It has been implemented in the true sense only in the department of space. For the rest of the ministries the success is negligible. However, the economic crisis through which India is passing, makes it imperative that ZBB is implemented in true spirit. In fact the system has failed to take off due to administrative problems.

## 12.9 KEY WORDS

**Decision Unit:** It is a distinct segment of an organisation for which budget is prepared. It is identified on the basis of functions, operations or activities of the organisation.

**Decision package:** A document that identifies and describes facts about an activity from every possible angle.

**Planning Programming Budgeting System (PPBS):** It is a technique for optimising allocation of funds in the budget through exercise of proper choice among programmes which compete for limited resources. This technique requires that the identification of goals or objectives to be achieved by the organisation be clear and specific. The next step is to search for alternative programmes for achieving these objectives most effectively and at least cost. The costs of each programme should be related to the corresponding output from them.

**Ranking:** Process of arranging activities in the order of their priority.

## 12.10 REFERENCES

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## 12.11 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

### Check Your Progress 1

1) Your answer should include the following points:

- Zero base budgeting is a system whereby each governmental programme, regardless of whether it is a new or existing programme must be justified in entirety each time a new budget is formulated.
- Whole of the budget must be annually justified from scratch in order to combat waste and complacency.
- It requires identification, examination, selection of the best alternatives through cost-benefit and cost-effective analysis.

2) Your answer should include the following points:

- In zero base budgeting all expenditures are thoroughly analysed from base zero while traditional budgeting usually begins with the estimation of current cost.

- Zero base budgeting facilitates shifting of resources from low to high priority areas while it is not possible with traditional budgeting.
- While zero base budgeting is decision-oriented approach which focuses on old and new activities, traditional budgeting is accounting-oriented which monitors expenditure.

### **Check Your Progress 2**

**1) Your answer should include the following points:**

- Introduction of ZBB in all departments of the Union Government in 1986-87 with a view to controlling government expenditure.
- Issue of budget guidelines by the Ministry of Finance to all ministry departments, state governments, public sector undertakings to apply ZBB to all schemes and programmes with over Rs. one crore outlay for the fiscal year 1987-88.
- Introduction of ZBB in some states like Maharashtra and Karnataka.

**2) Your answer should include the following points:**

- Identification of decision units and their objectives.
- Formulation and development of decision packages.
- Ranking of decision packages.
- Allocating resources to decision packages.

**3) Your answer should include the following points:**

- Identifies inefficient or obsolete duplication of activities.
- Facilitates critical review of all programmes/activities in terms of their cost-effectiveness and cost-benefits.
- Ensures greater participation of personnel in formulation and ranking process.
- Provides for quick budget adjustments during the year.
- Allocates scarce resources rationally.

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# UNIT 13 SOURCES OF REVENUE: TAX AND NON-TAX

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## Structure

- 13.0 Objectives
- 13.1 Introduction
- 13.2 Tax Revenue — Concepts and Classification
  - 13.2.1 Direct Taxes
  - 13.2.2 Indirect Taxes
- 13.3 Non-tax Revenue
- 13.4 Sharing of Receipts with States
- 13.5 Resource Mobilisation over the Years
- 13.6 Let Us Sum Up
- 13.7 Key Words
- 13.8 References
- 13.9 Answers to Check Your Progress Exercises

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## 13.0 OBJECTIVES

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After reading this unit, you should be able to :

- state the concepts and classification of tax revenue
- discuss the components of non-tax revenue
- describe the sharing of receipts with states; and
- explain trends in resource mobilisation over the years.

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## 13.1 INTRODUCTION

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Mobilisation of resources is a sine-qua-non for planned economic development of the economy. It becomes the means to the attainment of growth. The term resource mobilisation covers much more than taxation. It covers the income from public services, public enterprises and public utilities. A development plan, in order to be successful, should accord the highest priority to the generation of sufficient surplus from the current revenues of the government, its departmental units and the public enterprises. As development proceeds and the level of income in the economy rises, it should be able to mop up additional resources in the form of public borrowings and small savings. It may also be necessary to resort to deficit financing (about which we will discuss in detail in Unit 15) primarily to provide money for increasing transactions in the wake of rising incomes and growing monetisation of the economy. But at the same time care should be taken to ensure that it does not become inflationary. Similarly external assistance may be necessary as long as domestic resources do not prove adequate to finance the developmental programmes.

In this unit, we are concentrating mainly on two sources of revenue-tax and non-tax for resource mobilisation. The components of tax and non-tax revenue will be discussed and as an example provisions in regard to Budget of 1991-92 relating to resource mobilisation will be given.

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## 13.2 TAX REVENUE — CONCEPTS AND CLASSIFICATION

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The income of the government may be defined either in a broad or narrow sense. In a broad sense it includes all 'incomings' or 'receipts' and in the narrow sense only those receipts which are included in the ordinary concept of revenue. The chief elements which are included 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 most important source of government revenue is from taxes. A tax is a compulsory charge imposed by a public authority, like for example income tax. Sometimes description of taxes cover penalties for offences. The distinction between 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 certain things. Therefore, a tax is a compulsory contribution imposed by 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 between direct and indirect taxes. Direct tax is imposed and collected directly from the person on whom it is legally imposed while an indirect tax is imposed on one person, but paid partly or wholly by others. Thus 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 types of direct and indirect taxes.

### 13.2.1 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 ability, while in the case of indirect taxes, this ability is assessed indirectly. For instance, in case of income tax which is a direct tax, the amount of tax to be payable by a person, is determined on the basis of that person's income.

Let us discuss in detail the various direct taxes. These form source of revenue for the Union Government.

**a) 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 includes 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 certain incomes are totally exempt from tax. Some of these include, accumulated balance of recognised provident fund, death-cum-retirement gratuity, house-rent allowance upto a certain limit, scholarships granted to meet educational costs, post-office savings etc.

The budget 1991-92 proposed certain 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. 22,000. 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.

**b) Corporation tax :** In India, the companies are subjected to tax on their incomes which is called Corporation tax. Apart 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 different 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, types 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.

c) **Tax on Capital Gains** : This is the tax levied on the sale of any asset like land, building 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'. However, certain capital assets have been excluded from the purview of this tax, like consumable stores, raw materials, furniture etc.

d) **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 during the relevant previous year, after deducting all taxes on such income, exceeded Rs. 36,000. 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 capacity. But later in 1962, it was abolished, as it failed in curbing extravagant consumption or checking the evasion of other taxes. Again in 1987, the Expenditure Tax Act was introduced which provides 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 certain other categories of services. It will not apply to expenditure incurred in foreign exchange or in the case of persons enjoying diplomatic privileges.

e) **Wealth Tax** : The Wealth Tax Act, 1957 provides 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 included in the net wealth of an individual. But possession of amount of wealth to a certain limit is exempted from wealth tax. The Finance Act of 1985 enhanced the basic 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.

f) **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 which included cash, jewellery, household goods etc. A slab system was fixed according to which tax was levied. Later many changes were brought about under various 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.

g) **Gift Tax** : Gift tax was introduced in India in 1958. It is a tax imposed on gifts made by individuals, Hindu Undivided Families, Corporations, on the value of the taxable gifts made by them during the year. It is paid by 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 certain exemptions. These exemptions include 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 collected by the Union Government are distributed between the Union and states. We shall be discussing about these provisions in Section 13.4 of this unit. The direct tax revenues of the State governments include the State's share of income tax, estate duty, land revenue, urban immovable property tax etc.

### 13.2.2 Indirect Taxes

Having dealt with the various types 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 include sales tax, excise duties, entertainment tax, customs duties etc. One of the important reasons for increasing revenue from indirect taxes is with

increasing financial requirements of revenue, it is easier to impose and revise the indirect taxes than direct taxes.

a) **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 types of customs duties – import duties, export duties and cesses on exports.

i) **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 different rates of import duties leviable on different commodities. Generally 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 during 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 realisation 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 realisation is likely to be balanced to a great extent by 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 realisation (net) in 1991-92 shows an increase of Rs. 5,508.79 crore as compared to the revised estimate of 1990-91. The increase in gross revenue is expected mainly from crude petroleum and other petroleum products, electrical and nonelectrical 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.

ii) **Export duties** : Export duties before World War II, were levied with the prime objective of mobilising revenue. Later, during the post war period, they have been levied for other purposes. According to the Report of Taxation Enquiry Commission (1953-54), "several duties have been imposed for preventing the impact on domestic markets of inflationary conditions abroad, or for stabilising 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 during 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 many commodities like jute, tea, textiles and by the end of the third plan, these duties had to be practically abolished. Later again in 1966, these export duties were reimposed on many items due to competitive position of goods in international market.

Export duties are increased, reduced or abolished by the government from time to time keeping in view various 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.

b) **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 by 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 an important source of revenue for the Government of India because of growing 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 certain percentage of this value.

Union excise duties are levied on commodities covered by 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 however exempted from duty. The receipts during 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 basic and special excise duties in the revised estimate of 1990-91 as compared to the budget estimate is mainly on account of less revenue realisation from cess on crude oil, petroleum products, iron and steel, rubber products, etc.

c) **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'.

i) **Foreign Exchange Conservation (Travel) Tax** : In terms 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 authorised dealer or a money changer collects the tax from a traveller in respect of all foreign exchange released by him/her.

However, the following categories of foreign travel are exempted from payment of the tax :

- a) Medical treatment
- b) Studies abroad
- c) Haj and Ziarat pilgrimages
- d) Visits to Sikh shrines in Pakistan and Bangladesh
- e) Visits to Kailash Mansarovar

ii) The Foreign Travel Tax Scheme was introduced with effect from 15 October, 1971 through Finance Act, 1971. This was further amended by the Finance Act 1989. The amended scheme provides for a levy of a tax of Rs. 300 per passenger for international journey, (Rs. 150 for journey to the neighbouring countries). One per cent of the collection made, less refund, is paid to the carrier as collection charges.

iii) Inland Air Travel Tax was introduced through Finance Act 1989. The tax which was levied earlier at a rate of 10% of the basic fare is now levied on the full fare.

iv) 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 include state's share of union excise, state excise, general sales tax, motor vehicles tax, entertainment tax, electricity duties and other taxes and duties.

### Check Your Progress 1

Notes : i) Use the space given below for your answers.

ii) Check your answers with those given at the end of the unit.

1) What do you understand by direct taxes? State the types of direct taxes levied by the Union Government.

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## 2) What is Corporation Tax?

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## 3) What do you understand by Wealth tax?

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## 4) Distinguish between specific and ad valorem excise duties.

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### 13.3 NON-TAX REVENUE

The non-tax revenues of the Union Government include (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 include revenue from forests, opium, irrigation, electricity and dividends due from commercial and other undertakings.

Administrative receipts include state plan loans advanced to states by the Centre. In pursuance of the recommendations of the Ninth Finance Commission as accepted by the government, the state plan loans advanced to states during 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.

Table 1

	Interest receipts, Dividends and Profits (in Rs. Crores)		
	Budget 1990-91	Revised 1990-91	Budget 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

Sources : R.B.I. Report, Budget 1991-92 and Economic Survey 1991

**Interest on Loans to Union Territory Governments :** The interest receipts during 1990-91 is estimated at Rs. 16 crores and Rs. 18.71 crore in budget estimates of 1991-92 on loans advanced to Union Territory of Pondicherry.

**Interest payable by Railways :** In terms 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.

Sources of Revenue :  
Tax and Non-Tax

**Table 2**  
**International Financial Institutions**

	Budget 1990-91			Revised 1990-91		
	Receipts	Discharge	Net	Receipts	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
<b>Total</b>	<b>637.10</b>	<b>21.40</b>	<b>615.70</b>	<b>677.68</b>	<b>351.73</b>	<b>325.95</b>
<b>S.D.</b>	<b>1,250.17</b>	<b>1,033.73</b>	<b>216.44</b>	<b>2,736.26</b>	<b>2,562.35</b>	<b>173.91</b>

Source : Budget 1991-92

As a result of evaluation of Fund's holdings of Indian currency as on April 30, 1991 the budget estimates for 1991-92 provide 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. During 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 include administrative receipts, net contribution of the public sector undertakings grants-in-aid and other contributions.

## 13.4 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 between the centre and states in the fields of taxation, the following constitutional provisions have been made.

- 1) There is no tax which can be levied by 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 important taxes falling in this category are sales tax, land revenue, state excise duties, entertainment tax etc.
- 2) Some taxes are levied by the central government but their proceeds are divided between 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 between the centre and the states is recommended by the Finance Commission.
- 3) The power to levy and collect certain taxes is vested in the centre, whereas their revenue proceeds are to be distributed among the states. Estate duty on property other than agricultural land, duty on railway freights and fares, terminal tax on goods and passengers carried by railways or purchase of newspaper and

Though some taxes are levied by the central government, the responsibility to collect them is on the state government. For instance, stamp duties other than those included in the Union list and excise duties on drugs and cosmetics have been included in this category.

There is need for decentralisation of functions for encouraging local initiative, for securing promptness in decision-making and efficiency in its implementation, and for allowing for a variety of experiments to suit varying needs, tastes and temperaments — this is implied in the federal nature of the Constitution which ensures immediate effective resource mobilisation and maintenance of national perspective.

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

**Table 3**  
**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

Source : Budget 1991-92

There exists a conflict between 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 recognised as a permanent statutory body. Its scope and functions must be widened by suitable constitutional amendments.

The devolution of revenues from centre to states should be in conformity with economy, administrative convenience and efficiency. It should be able to provide national minimum to people. The ideal way of achieving this is to transfer resources from richer to poorer states. While transferring resources to states, population, climate and rainfall, state of economic development should be kept in mind.

Central Government should not make directly any loans to states. State Governments should be encouraged to borrow directly from the public as much as they can.

An important development in the sphere of centre-state financial relations in the recent years relates to the states taking recourse to unauthorised overdrafts with the RBI. Two factors, namely, temporary difficulties because of the uneven flow of receipts and expenditures and chronic imbalances between their functions and resources 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 resources. Most of the projects on which the state governments invested capital by 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 exploit their resources fully.

### **13.5 RESOURCE MOBILISATION OVER THE YEARS**

India has done extremely well in terms of tax effort. In 1950-51 when the planning process 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% (approximately) today. For a developing country like India which started its development effort with a very low per capita income and has recorded an extremely modest rate of growth (i.e. around

1.5% per annum increase in NNP per capita), this record in mobilising tax revenue is remarkably good by 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 mobilisation of resources 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.

Apart from tax revenue other important aspects of resource mobilisation are generation of non-tax revenues, restricting of current government expenditure and raising of surpluses of public sector enterprises.

Additional resource mobilisation measures undertaken in the 1990-91 budget 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 mobilisation after making 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 an 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 thus estimated at Rs. 3327 crore in 1990-91.

Net profits (after tax) of central government public enterprises increased substantially from Rs. 2994 crore in 1988-89 to Rs. 3782 crore in 1989-90. The rate of return, as measured by the ratio of net profits to capital employed, rises to 4.5% in 1989-90, which is the highest achieved in the decade. However the petroleum sector accounted for the bulk of these profits, i.e. Rs. 2,900 crore out of the total Rs. 3,782 crore in 1989-90. The non-petroleum sector enterprises numbering about 200 contributed a meagre 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 indicates 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 during the corresponding period of 1989-90.

The seventh plan envisaged generation of internal resources to the extent of Rs. 23,013 crore and additional resource mobilisation to the extent of Rs. 11,490 crore at 1984-85 prices for financing the plan outlays. Against this during the seventh plan, the public enterprises have generated gross internal resources of Rs. 37,715 crore at current market prices. About 32% of plan investment in central public enterprises during the seventh plan was financed by generating net internal resources – 28% by extra-budgetary resources and 40% by the budgetary support.

The outlook on the resource mobilisation front is serious but not unmanageable. The resource imbalances accumulated over several 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 during 1990-91, which aimed at better revenue collections and containment of public expenditure have had a limited effect as evidenced by 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 difficult choices. Any beginning should aim at strict control over government expenditure, particularly the revenue and non-plan expenditure, rationalisation of subsidies so that they are better directed towards the poor and improvement in revenue collections. Continued effort on the part of the government may provide the basis for a transition to a sustainable resource regime over the next few years.

### Check Your Progress 2

- Notes : i) Use the space given below for your answers.  
ii) Check your answers with those given at the end of the unit.

- 1) What are the non tax revenue sources of the union government?

- 2) Discuss the Constitutional provisions relating to sharing of tax receipts between the Centre and States.

### 13.6 LET US SUM UP

Resource mobilisation includes not only taxation but also income from public services, public enterprises and public utilities. In this unit, we have discussed the two main sources of revenue-tax and non-tax. Taxation is a very important source of revenue. Taxes are of two types—direct and indirect. We have examined the important direct taxes which form the source of revenue for Union Government. This includes incometax, corporation tax, tax on capital gains, expenditure tax, wealth tax, estate duty, gift tax. Indirect taxes form a very important source of revenue to the government. Import duties, export duties, union excise duties, other taxes like foreign travel tax, foreign exchange etc. are included under indirect taxes, which have been dealt with in the unit.

The non-tax revenues of the union government consist of administrative receipts, net contribution of public sector undertakings and other revenues. We have discussed the Constitutional provisions regarding sharing of proceeds of revenue between the Centre and state governments, and resource mobilisation over the years.

### 13.7 KEY WORDS

**Closely held Companies :** These are companies in which more than fifty per cent shares are held by five or less than five persons.

**Dividend :** It is the share of profits earned from a company, either by the government or any individual as holder of shares in that company.

**Finance Commission :** Article 280 of the Indian Constitution provides for the setting up of Finance Commission once in every five years, to recommend to the President measures relating to the distribution of financial resources between the centre and the states. It is entrusted with the task of distribution between the union and the states of the net proceeds of the taxes which are to be or may be divided between them and the allocation between the states of respective shares of such proceeds.

**Per capita income :** Average income per member of the population of a particular country.

**Special Drawing Rights (SDR's) :** It is an international reserve currency system which was created by the International Monetary Fund (IMF) in 1969. SDR's are used along with gold and dollars as monetary reserves and accepted and used by any member of the IMF as a means of payments between central banks in exchange for existing currencies. SDR's which supplement gold and convertible currencies are created annually and are apportioned to members according to their (the countries) size, importance and requirements.

**Taxation Enquiry Commission :** This Commission was set up in 1953 under the

chairmanship of Dr. John Mathai to review the whole Indian tax structure to make it more equitable and sound.

Sources of Revenue :  
Tax and Non-Tax

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## 13.8 REFERENCES

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## 13.9 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

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### Check Your Progress 1

- 1) Your answer should include the following points :
  - Direct tax is a tax imposed and collected directly from the person on whom it is legally imposed.
  - It is a tax the incidence of which falls on the person concerned and cannot be shifted or passed on to another person.
  - The direct taxes comprise income tax, corporation tax, capital gains tax, estate duty, gift tax, wealth tax.
- 2) Your answer should include the following points :
  - It is the tax levied on the incomes of the companies.
  - It is levied at a flat rate and subject to a number of rebates and exemptions.
  - Corporation tax does not include the tax deducted by the companies from the dividends of the share holders.
- 3) Your answer should include the following points :
  - The Wealth Tax Act 1957 provides for levy of a tax on the net wealth of every individual, Hindu Undivided families and closely held companies.
  - Agricultural property is not included in the net wealth of an individual.
- 4) Your answer should include the following points :
  - Specific excise duties are those which are levied at a specified rate per unit of the physical product.
  - Ad valorem duty is that which is related to the monetary value of the commodity and levied at certain % of this value.

### Check Your Progress 2

- 1) Your answer should include the following points :
  - The non tax revenue sources of the Union Government include (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 include revenue from forests, opium, irrigation, electricity and dividends due from commercial and other undertakings.
- 2) Your answer should include the following points :
  - There is no tax which can be levied by both the Centre and the states. The custom duties and the Corporation tax fall within the purview of the Central Government. The states also have power to levy some other taxes to finance their activities. This include sales tax, land revenue, entertainment tax etc.
  - Some taxes are levied by the Central Government but their proceeds are divided between the Centre and the states like Union excise duties.
  - There are certain taxes like estate duty on property other than agricultural land, duty on railway freights and fares etc., which are levied and collected by the Centre only, but the proceeds are to be distributed among the states.

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# UNIT 14 DEFICIT FINANCING

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## Structure

- 14.0 Objectives
- 14.1 Introduction
- 14.2 Deficit Financing — Concept and Meaning
- 14.3 Role of Deficit Financing as an Aid to Financing Economic Development
- 14.4 Deficit Financing and Inflation
- 14.5 Deficit Financing and Price Behaviour in India
- 14.6 Advantages of Deficit Financing
- 14.7 Limitations of Deficit Financing
- 14.8 Measures/Alternatives to Control Deficit Financing
- 14.9 Let Us Sum Up
- 14.10 Key Words
- 14.11 References
- 14.12 Answers to Check Your Progress Exercises

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## 14.0 OBJECTIVES

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After reading this unit you should be able to :

- explain the meaning of deficit financing
- discuss the role of deficit financing as an aid to financing economic development
- describe the relationship between deficit financing and inflation
- state the impact of deficit financing on price behaviour in India
- point out the advantages and limitations of deficit financing; and
- suggest measures to control deficit financing.

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## 14.1 INTRODUCTION

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The government is committed to socio-economic responsibilities for breaking the vicious circle of poverty and uplifting the economic conditions of the masses and developing the economy into a self-reliant one. In 1950, it was thought that these objectives could be achieved through the process of planned economic development. Throughout the period of planned economic development in the country one basic problem has been that of mobilisation of resources.

Sources of financing economic development are broadly divided into domestic and foreign sources. Domestic sources of finance at the disposal of the government consist of taxation, public borrowing, government savings which include surpluses of public enterprises and deficit financing. The foreign finances consist of loans, grants and private investments. All these sources of finance have their social costs and benefits on the basis of which an upper limit can be determined for the use of any one method of financing development. Since the financial requirements of development are enormous and all various sources have their own limitations, it becomes almost essential to make use of all the sources as far as possible. The choice is not between which one is to be used but between the various combinations of using all of them. Thus both the domestic and foreign sources of finance have their own place and importance in a developing country. It is essential to formulate appropriate policies for different sources of finance and successful implementation of these policies is required for achieving the desired objectives of rapid economic development.

Taxation is an old source of government revenue. Not only that, it is also regarded as the most desirable method of financing public investment in developing countries. But it is a well known fact that taxation has a narrow coverage in developing countries and the tax revenue/national income ratio is not only low but the increase in this ratio is also very slow during the process of development.

Public borrowing is considered a better method of collecting public revenue than



taxation (on the one hand government will get sources for development programmes and, on the other, conspicuous consumption will be reduced). But it cannot substitute taxation completely because there are certain limitations to the use of this source of financing development. Firstly public borrowing depends on the credit worthiness of the government. Secondly, people do not want to lend to the government because the rates of interest offered by the government are lower than those offered by the borrowers in the private sector. And thirdly, if the prices are rising, people will not be interested in saving and lending because of depreciation in the value of money. We shall be discussing about public borrowing as a source of resource mobilisation in detail in the next Unit i.e. 15.

Domestic sources of financing economic development are sure to fall short of the huge financial requirements for rapid economic development in developing economies. So external sources of finance have become almost essential for the developing economy. In spite of the necessity of foreign assistance, it remains only a subordinate source of financing development in a developing economy. In the early stages of development a substantial foreign assistance may be needed but gradually foreign assistance as a percentage of development expenditure goes on diminishing as the developing nations must learn gradually to become self reliant.

Hence various conventional sources of finance, such as taxation, public borrowing, having been found to be inadequate, deficit financing has been resorted to for meeting the resource gap. The idea of resorting to deficit financing for economic development, which is of relatively recent origin, has remained very controversial. But there are no two opinions regarding the evil consequences of deficit financing, when adopted carelessly for capital formation and economic development. But the problem before the country is to choose between the two evils i.e. to adopt deficit financing for capital formation and face inflation or to go without development programmes due to paucity of funds.

In this unit we will discuss the meaning of deficit financing and its role as an aid to financing economic development. We shall also highlight the relationship between deficit financing and inflation and its impact on price behaviour in India. The advantages and limitations of deficit financing are also dealt with.

## **14.2 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 generally used to refer to the financing of a planned deficit whether operated by 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 between public revenue and expenditure or a budgetary deficit. This gap is filled up by government borrowings which include 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 included 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 by 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 included 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, therefore, 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 by running down its accumulated balances or by borrowing from the banking system (mainly from the Central Bank of the country) and thus 'creating money'. Thus, 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 by withdrawing its cash balances from the Central Bank.

The magnitude of actual budget deficit during 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 nearly 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 growing year after year. For example the revised estimates place the deficit on revenue account during 1990-91 at Rs. 17,585 crore as against the budget deficit of Rs. 10,772 crore. A higher revenue deficit implies higher borrowed resources to cover the deficit leading to higher interest payments thus creating a sort of vicious circle.

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### 14.3 ROLE OF DEFICIT FINANCING AS AN AID TO FINANCING ECONOMIC DEVELOPMENT

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

#### **Deficit financing during war**

Deficit financing has its historical origin in war finance. At the time of war, almost every government has to spend more than its revenue receipts from taxes and borrowings. Government has to create new money (printed notes or borrowing from the Central Bank) in order to meet the requirements of war finance. Deficit financing during 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 during depression**

The use of deficit financing during times of depression to boost the economy got impetus during the great depression of the thirties. It was Keynes who established a positive role for deficit financing in industrial economy during the period of depression. It was advocated that during 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 utilisation of already existing but temporarily idle plants and machinery. Deficit spending by the government during depression helps to start the stagnant wheels of productive machinery and thus promotes prosperity.

#### **Deficit financing and economic development**

Deficit financing for development, like depression deficit financing, provides stimulus to economic growth by 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 different. When government resorts to deficit financing for development, large sums are invested in basic 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 called the inflationary way of financing development. However, it helps rapid capital formation for economic development.

## 14.4 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 resources which can be employed by raising government investment through deficit financing. The result will be an increase in output, income and employment and there is no danger of inflation. The increase in money supply leading to demand brings about a corresponding increase in the supply of commodities and hence there is no increase in price level.

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 different. Public outlays financed by newly-created money immediately create 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), most of it goes to industries with long gestation period and for providing basic infrastructure. Though there is effective demand, resources lie under or unemployed. Lack of capital, technical skill, entrepreneurial skills etc. are responsible in many cases for unemployment or underemployment of resources in a developing economy. Under such conditions, when deficit financing is resorted to, it is sure to lead to inflationary conditions.

Besides, in a developing economy, during the process 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 by commercial banks because their liquidity is increased by the creation of new money. This shows that in a developing economy total money supply tends to increase much more than the amount of deficit financing, which also aggravates inflationary conditions. The use of deficit financing being expansionary becomes inflationary also on the basis of quantity theory of money.

### Check Your Progress 1

**Note:** i) Use the space given below for your answers.  
ii) Check your answer with those given at the end of the unit.

- 1) Explain the meaning of deficit financing.

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- 2) How does the concept of deficit financing, as existing in the West, differ from that in the Indian context?

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- 3) Deficit financing in a developing country is inflationary while it is not so in an advanced country. Discuss.

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## 14.5 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 create an atmosphere of uncertainty which is not conducive to development activity. When we examine the price movements during the planning period in India, there are three clear trends. First during the first plan period (i.e. 1951 to 1956) the general price level 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. During the first plan deficit financing was of the order of Rs. 333 crore and the money supply with the public increased by about 22 per cent. Since this expansion in the supply of money fell short of the increase in output, the general price level came down by about 18 per cent. During second plan, actual deficit financing was less than the targeted amount.

The third plan was very abnormal (adverse weather conditions, 1962 Chinese aggression, 1965 Pakistan war). Deficit financing during 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 by 47% approximately. No doubt there were certain 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 mobilise adequate resources, 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.

During this period, although the money supply increased by about 50 per cent, the overall increase in wholesale prices was 33% because of the imposition of emergency in 1975 resulting in comfortable position in regard to the availability of several commodities through the effective management of supplies.

During 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. During 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 cautious approach towards deficit financing and stated that "The required resources have to be mobilised in a manner which minimise 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 during the same period.

There were many other factors like mismanagement of the war economy, excessive dependence on monsoon, power shortage, labour strikes, increase 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. However, experience shows that the increase in money supply has led to a rise in prices. There has been a close relationship between the rate of increase in prices and the rate of growth in money supply and prices have a tendency to rise to new heights at every successive increase 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 simply lead to continuous inflation and no development. Inflation creates 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 levels of income accruing to profit earners will be invested in 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 channelising economic resources into less urgent and speculative fields where the scope for profits to private enterprises is more and such fields are generally 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 neutralise its effects by sanctioning new dearness allowances, revision of controlled prices, distribution of essentials through fair price shops, compulsory requisition of foodstuffs etc. All these measures lead to an increase in the administrative burden of the government in order to ward off inflation caused by the use of deficit financing.

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## 14.6 ADVANTAGES OF DEFICIT FINANCING

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Uptill 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 certain extent inflation is conducive to economic development and hence deficit financing is beneficial.

During the process of development, increase in national production is bound to give rise to the demand for increased money supply for transactions. This can be met by 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 example, 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 increase 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 by 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 by increasing exports and reducing imports.

Deficit financing will be non-inflationary if the government is able to mop up the additional money incomes, created by deficit financing, through taxation and saving schemes. Properly controlled and efficiently managed programme of deficit financing may help the process of economic development. In fact a certain measure of deficit financing is inevitable under planned economic development to activate unutilised or dormant resources especially when one of the objectives of planning is to step up the tempo of economic process.

Inflationary impact of deficit financing is helpful for economic development to a certain extent and under certain circumstances like :

- a) Under developed countries, with their low incomes, low or negative savings, inadequate investment and traditional resistance to change and modernisation, will remain stagnant or develop at an intolerably slow pace unless they are restructured and activated. This can be done with the stimulus of inflation.
- b) 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 process is repeated there is every possibility of a rapid rate of capital formation in the country. For this, inflation may be tolerated to a certain extent.
- c) Inflation is said to be a useful method of increasing 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 provides resources for investment purposes.

Thus, 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.

## 14.7 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 called 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 must be kept at a low level 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. However, 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. Unfortunately conditions in a developing country are not so simple. Various factors simultaneously exert contradictory effects on each side.

### Factors Affecting Safe Limit

- i) The safe limit of deficit financing depends on the supply elasticity of consumption goods in the country. Usually, the supply of consumption goods, specially foodgrains, cannot be increased to any extent for a long time due to many 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.
- ii) 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 intensive farming.

- iii) If the foreign exchange reserves are increasing the scope of using deficit financing will increase because that way the country will be able to import more goods which will have deflationary effect.
  - iv) Time lag between 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.
  - v) Low safe limit of deficit financing is required if the economy consists of large speculative business community.
  - vi) 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.
  - vii) If a country is already passing through inflationary phase, low deficit financing is advised.
  - viii) If the rate of growth of population is high then low deficit financing is good and vice versa.
  - ix) Safe limit deficit financing also depends on a country's tax structure and the borrowing schemes through which the government can take away 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 away any substantial part of additional incomes. The country is, therefore, 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 favourable or unfavourable for the use of deficit financing and sometimes the effects of some factors may counter effect each other and, thus, be cancelled out. This safe limit of deficit financing will be different for different countries because conditions 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 conditions 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 by a government which is conducive to economic development and not inflation.

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## 14.8 MEASURES/ALTERNATIVES TO CONTROL DEFICIT FINANCING

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Besides open deficit financing undertaken by the government, there is concealed deficit financing in developing economies. In all government departments, in a developing country most 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 by 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. Most of the havoc created in the economy is actually created by this concealed deficit financing. If, by 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 cheque transactions, under invoicing and over invoicing of export and imports, and a variety 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 must try to remove reckless expenditure in public and private sectors caused by 'concealed deficit financing' and 'unrecorded gains' instead of stopping the use of deficit financing which is likely to be spent productively and therefore help in the economic development of the country.

In order to minimise the inflationary effects of deficit financing during the process of

development the government will have to keep a vigilant and constant watch on changing economic situations, study the repercussions of measures adopted in several spheres and, above all, take effective action on following lines :

- a) Government should try to drain off a larger proportion of funds resulting from deficit financing through saving campaign and higher taxation.
- b) The policy of deficit financing should be adopted as a last resort, after exhausting all other possible sources of development finance.
- c) Investment should be channelled into those areas where capital output ratio is low so that returns are quick and price rise is not provoked.
- d) Along with deficit financing, government should adopt policies of physical controls like price control and rationing etc.
- e) Import policy should allow import of necessary capital equipment for economic development and consumer goods required by the masses alone. Import of luxury and semi-luxury goods should be discouraged.
- f) 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 resources 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 process of economic development itself is inflationary. Whenever new investment is financed by taxation or borrowing, the result is an increase in monetary incomes, increase in demand for consumption goods, and price rise. With this background the important 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 process. Thus 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 emphasise here that it must be undertaken with an efficient and well executed plan for economic development.

### Check Your Progress 2

Note : i) Use the space given below for your answers.

ii) Check your answers with those given at the end of the unit.

- 1) When deficit financing is inflationary, it will go against the very purpose for which it is used because it will simply lead to continuous inflation and no development. In the light of the statement, comment on the negative effects of inflation on the economy.

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- 2) What do you understand by safe limit of deficit financing? List atleast three factors affecting safe limit.

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## 14.9 LET US SUM UP

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Deficit financing as a method of resource mobilisation has assumed an important place in public finance in recent times. It refers to the means of financing the deliberate excess of expenditure over income through printing of currency notes or through borrowing. In this unit, we have discussed the meaning of deficit financing, its role as an aid to financing economic development in various situations. Deficit financing in a developing country becomes inflationary and it has varied effects on economic development which have been highlighted in the unit. We have also examined the impact of deficit financing on price behaviour in India during the plan period. It shows that, apart from other factors, there has been a close relationship between rate of growth of money supply resulting from deficit financing and rate of increase in prices. But to a certain reasonable extent, deficit financing has proved to be conducive to economic development, especially in countries with acute shortage of capital. The advantages of deficit financing in this context have been dealt with in the unit. As we have discussed in the unit deficit financing in developing economies can be regarded as a necessary evil which can be tolerated only to the extent it promotes capital formation and economic development. This extent of tolerance is known as safe limit of deficit financing. To minimise the inflationary effects of deficit financing during the process of development, certain measures have to be taken like proper channelising of investment in areas with low capital output ratio, adoption of policies of physical control like rationing, import of only necessary capital equipment etc. In economies with low capital formation, deficit financing becomes a necessary and positive instrument if used with efficient and well executed plan of economic development.

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## 14.10 KEY WORDS

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**Balance of Payments :** It is a kind of income statement that records all transactions between individuals, firms and governmental units of one nation and individuals, firms, governmental units of all other nations. It gives a record of all transactions between the residents of country and rest of the world with payments expressed in terms of the country's currency.

**Capital-Output Ratio :** It refers to the economy's total stock of real capital divided by the level of its income or output.

**Capital account :** The section of the national income accounts which record investment expenditure incurred by government on infrastructure such as roads, hospitals and schools and investment expenditure by the private sector on plant and machinery.

**Credit creation :** It refers to the process in which the group of deposit taking and lending institutions on the basis of an increase in their reserve assets produce an increase in the volume of their lending and of the associated deposit liabilities.

**Deflation :** In contrast to inflation, deflation refers to a decline in the general price level of all goods and services equivalent to a rise in purchasing power of money. While in the state of inflation, there is a fall in the value of money with increasing prices, during deflation, with fall in the prices, there is increase in the value of money.

**Gestation period :** It refers to the period taken from the conception or initiation of the project till its final completion or production stage. For example, while cottage industries may need less gestation period, say a few months, an industrial steel or

energy plant may require quite a few years gestation period.

**Invoicing** : An itemised statement of goods or services brought or sold usually including a request for payment.

**Marginal propensity to consume** : The relationship between the community's income and what it can be expected to spend on consumption will depend on the psychological characteristics of the community which is called its propensity to consume.

**Multiplier effect** : The doctrine of multiplier states that any given increase in investment (private or government) will result in an increase in national income as a multiple of the increase in investment. For example, money spent in building a new plant, sets off a chain reaction. It increases the income of the workers directly engaged in its construction, the incomes of the merchants with whom the workers trade and so on. Multiplier effect implies that an original excess of investment over savings may over a longer period of time increase money income by several times the primary excess.

**Overdraft** : Borrowing money in excess of what one is entitled to, till the balance in the account becomes negative.

**Quantity theory of money** : The theory states that the level of prices in an economy varies directly with the quantity of money in circulation provided the velocity of circulation of that money and the volume of trade which it is obliged to perform are not changed.

**Revenue account** : It means the total income of a business or government, generated by the sale of goods only or income generated from sources other than sales.

**Velocity of circulation of money** : The average number of times a unit of money is spent during the period under consideration, a year for instance.

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## 14.11 REFERENCES

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## 14.12 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

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### Check Your Progress 1

1) Your answer should include the following points :

- Deficit financing refers to the means of financing the deliberate excess of expenditure over income through printing of currency notes or through borrowing.
- It is resorted to for financing a planned deficit incurred by the government in management of its domestic affairs or with reference to balance of payment deficit.

2) Your answer should include the following points :

- The concept of deficit financing in the West implies financing of a deliberately created gap between public revenue and expenditure. This gap is filled by government borrowings from all the sources i.e. from people; commercial banks and the central bank.

- Deficit financing as used in the Indian context is resorted to when there are budgetary deficits. Government borrowing from public and commercial banks does not come under deficit financing as in the West. In Indian context, borrowing from the Central Bank of the country, withdrawal of accumulated cash balances and issue of new currency are included within the purview of deficit financing.

3) Your answer should include the following points :

- Deficit financing in a developing country gives rise to various effects in the economy.
- Public outlays financed by newly created money immediately create monetary incomes and, due to low standards of living and high marginal propensity to consume, demand for consumption goods and services increases.
- The production of consumption goods being time consuming, with immediate rise in monetary income, there is increase in prices.
- Most of the investment that is raised goes to industries with long gestation period.
- Resort to deficit financing in a developing economy where there is lack of capital, technical skill, entrepreneurial skills etc. leads to inflationary conditions.

### Check Your Progress 2

1) Your answer should include the following points :

- Inflation creates uncertainty, labour unrest, work stoppages, decline in production due to demand for higher wages and salaries.
- Reduction in the real income and real consumption of all classes of people in the society except the rich.
- Investment in unproductive, speculative activities by the profit earners.
- Reduction in value of incomes and cash balances.
- Balance of payments difficulties, with losing export market and increase in imports.

2) Your answer should include the following points :

- The extent to which deficit financing has to be tolerated in developing economies, so that it can promote capital formation and economic development, is known as the safe limit of deficit financing.
- Your answer regarding the factors affecting the safe limit can include any three of the factors discussed in Section 14.7.

3) Your answer should include the following points :

- Effective saving campaign and higher taxation to divert a larger proportion of funds resulting from deficit financing.
- Channelling of investment into those areas where capital output ratio is low.
- Adoption of policies of physical control like price control, rationing etc.
- Import of necessary capital equipment for economic development and consumer goods required by masses.
- Proper integration of deficit financing and credit creation policies.

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# **UNIT 15 PUBLIC DEBT MANAGEMENT AND ROLE OF RESERVE BANK OF INDIA**

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## **Structure**

- 15.0 Objectives
- 15.1 Introduction
- 15.2 Public Debt — Meaning and Causes
- 15.3 Classification of Public Debt
- 15.4 Public Debt Management
- 15.5 Public Debt and Economic Development and Inflation
- 15.6 Trends and Structure of Public Debt in India
- 15.7 Role of Reserve Bank of India in Public Debt Management
- 15.8 Let Us Sum Up
- 15.9 Key Words
- 15.10 References
- 15.11 Answers to Check Your Progress Exercises

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## **15.9 OBJECTIVES**

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

- state the meaning and causes of public debt
- list various types of public debt
- explain the important elements of public debt management
- discuss the relationship between public debt, economic development and inflation
- describe the trends and structure of public debt in India; and
- discuss the role of the Reserve Bank of India in public debt management.

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## **15.1 INTRODUCTION**

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We have discussed in the previous unit on Deficit financing that the problem of resource mobilisation is causing a concern in present times in achieving a self-reliant economy. As said earlier, the government finances its expenditure through conventional sources like taxes, public borrowing or printing money. With the government undertaking programmes of planned economic development on a large scale, it is not possible to meet the related expenditure either entirely through taxation or creation of new money. There is a certain limit beyond which revenue from taxation cannot be raised as it would affect the level of investment, production in the country and people's paying capacity. Also financing the programmes through creation of new money beyond a certain level becomes inflationary. Hence resort to public borrowing as a method of resource mobilisation has become an increasing phenomenon in present times. Public borrowing helps in discouraging unproductive expenditure and diverts the savings of the people for capital formation, financing new developmental projects etc.

In this unit, we shall discuss the meaning of public debt, reasons for resorting to public borrowing and types of public debt. The unit highlights the elements of public debt management, trends and structure of public debt in India and the role of Reserve Bank of India in public debt management.

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## **15.2 PUBLIC DEBT — CONCEPT AND CAUSES**

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Modern fiscal policy endorses unbalanced government budgets for purposes of stimulating economic growth and stabilising economy, its application leading to a

growing public debt. Growth of public debt has been quite substantial in almost all developing economies in recent years. We shall be discussing this in detail with special reference to India in Section 15.6 of this unit.

Public debt in simple words means debt incurred by the government in mobilising savings 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 by classical economists like Hume and Adam Smith who considered 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, increase 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. Building up the economic infrastructure like railways, roads, bridges, power plants etc. that provide the base for economic development, requires huge investments which the government cannot finance just through taxation.
- Another reason for the growth in public debt is due to both the Central and state governments lending significant 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 increase in governmental activities result in increasing expenditure that make the government resort to public borrowing.

In recent years, factors like increase in prices, enlargement of administrative services, increasing expenditure on defence, wages and dearness allowances etc., have also contributed to increase in public debt.

### 15.3 CLASSIFICATION OF PUBLIC DEBT

As said earlier, one method by which a public authority may obtain income is by borrowing. The proceeds or whatever is collected 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 thus created form part of public expenditure.

Public debt can be classified in many ways. Let us now discuss some important classifications :

#### 1) Reproductive and Unproductive Debt

A distinction is, often, drawn between 'reproductive debt' and dead weight debt or unproductive debt. The former is a debt which is fully covered or balanced by the possession of assets of equal value. These debts are incurred generally 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 by 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 example. The interest and sinking fund, if any, on this type of debt must be obtained from some other source of public income, generally from taxation and, since there is no corresponding asset created, there is no rule regarding the period of repayment.

## 2) Voluntary and Compulsory Debt

Public debts are incurred through public loans. There are two types of loans — voluntary and compulsory. Voluntary loans are those regarding which people are free to subscribe to government's securities whenever they are floated. The chief advantage of a voluntary loan, 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.

## 3) Internal and External Debt

Public debt may be internal or external. It is internal if subscribed by 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.

## 4) 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 between "funded" and "floating or unfunded" debt is roughly equivalent to that between long and short-term debt. Funded or long-term debts are repayable after a year while unfunded debts are generally incurred for a short-term and must be repaid within a year. It includes 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.

## Check Your Progress 1

Note: i) Use the space given below for your answers.  
ii) Check your answers with those given at the end of the unit.

1) State the causes for public borrowing.

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2) Distinguish between reproductive and unproductive debt.

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3) What are internal and external debts?

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## 15.4 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 most careful economic analysis. It is all the more important 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 ability 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 by 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. Thus 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 provide funds to retire or repay the maturing bonds. Rather, the government simply 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, by the fiscal and monetary authorities, the size and composition of debt, the maturity pattern, interest rates, redemption of debt etc. Keeping in view the increasing magnitude of public borrowing both internal and external, about which we will discuss in subsequent sections, the extent to which the government can mobilise funds from public depends upon the skilful public debt management.

In this task, various aspects 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 example, if both the central and state governments decide to go in for public borrowing, details need to be worked out regarding the amount, interest rates and other terms and conditions 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 important methods usually adopted for the retirement of public debt. These include the following :

- i) Refunding
- ii) Conversion
- iii) Surplus Budget
- iv) Sinking Funds
- v) Terminable Annuities
- v) Additional Taxation
- vii) Capital levy
- viii) Surplus balance of payments

- i) Refunding of debt implies the issue of new bonds and securities by the government in order to repay the matured loans. In the refunding process, usually short-term securities are replaced by long-term securities. Under this method the money burden of debt is not relinquished but is accumulated owing to the postponement of debt redemption.

- ii) Conversion of public debt implies changing the existing loans, before maturity, into new loans at an advantage. In fact, the process of conversion consists generally 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 minimise the burden. Thus the obvious advantage of such conversion is that it reduces the burden of interest on the tax-payers. The success of conversion, however, 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 difference between refunding and conversion is that in the case of the latter, there can be a change in rate of interest and other terms.
- iii) Quite often, surplus budget (i.e., by spending less than the public revenue obtained) may be utilised for clearing of public debts. But in recent years, due to ever-increasing public expenditure, surplus budget is a rare 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 considered suitable for retirement of any debt.
- iv) A sinking fund is created by the government and it is gradually accumulated every year by setting aside a part of current public revenue to be deposited in the fund in such a way that it would be sufficient to pay off the funded debt at the time of maturity. Perhaps, this is the most 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 among the lenders and thereby the credit-worthiness of government increases. A sinking fund is however, a slow process of debt redemption. Moreover, during an emergency or financial stringency, the government is tempted to encroach upon such funds.
- v) 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 by issuing terminable annuities to the bond holders which mature annually. This is the method of redeeming debt in instalments. By this method the burden of debt goes on diminishing annually and by the time of maturity, it is fully paid off.
- vi) 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 by transferring the resources 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.
- vii) Capital levy is strongly recommended by 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 generally imposed after a war to repay unproductive war debts.
- viii) The retirement of external debt, however, is possible only through an accumulation of foreign exchange reserves. This necessitates creation of a favourable balance of payments by the debtor country by augmenting its exports and curbing its imports, thereby improving the position of its trade balance. Thus the debtor country has to concentrate on the expansion of its export sector industry. Further, loans raised must be productively utilised, 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 by changing the terms of repayment or rescheduling the debt.

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## 15.5 PUBLIC DEBT AND ECONOMIC DEVELOPMENT AND INFLATION

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The existence of a large public debt does pose real and potential problems. 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 resources available initially, but reduces the resources available in the future. To meet the interest and repayment charges owed to the outside world, the government must 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 simply makes the resources that were available earlier in exchange for the commitment to pay interest. The initial increase in total available resources is made possible by borrowing done outside the community. Similarly, interest and repayment means that the community gives up resources to the outside world later.

When government borrows within the country, total resources available to the country as a whole are not increased. The resources are simply transferred from bond payers i.e. people to the government. Similarly, the interest and repayment charges do not transfer resources 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. Thus 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 capacity to produce, hence a smaller output. Debt financing also reduces private investment. Firstly under conditions of full employment and with an unchanged monetary policy, when the government borrowing is competitive with private borrowing, interest rates will be raised by the deficit, and investment will be reduced. This is usually called "*Crowding out Effect*" (Government borrowing will increase the interest rate and reduce private investment). Secondly, investment may also be reduced by the presence of an existing public debt. Consumers may consider their bond holdings to be a part of their wealth which would make them feel wealthier, raise their consumption, and cut their saving. Further, the higher taxes to cover the interest must have some negative influence on investment. Finally, the existence 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 difficult to evaluate.

The average citizen fears the debt mainly as a source of inflation. The debt represents past outlays that were not matched by taxes, hence it measures past government claims to resources that it could not pay for. If government engages in debt financing when the economy is already at full employment, existence 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, therefore, constitute a potential backlog of purchasing power which can add materially to inflationary pressures. During periods of inflation, it is very tempting for consumers to utilise this reserve of purchasing power in an attempt to beat rising prices. Such an attempt to tackle inflation will cause more inflation.

Uptil 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 growing 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 level of employment, this expanding volume of saving or its equivalent must be obtained and spent by the consumers, business houses or government. The process by which saving is transferred to spenders is debt creation. Whenever government issues bonds, since these are highly liquid and risk free securities, they make an excellent purchase for small and

conservative savers. To the extent that the availability of bonds encourage saving, more resources are freed for investment and economic growth tends to be enhanced.

## 15.6 TRENDS AND STRUCTURE OF PUBLIC DEBT IN INDIA

Modern fiscal policy endorses unbalanced government budgets for purposes of stimulating economic growth and stabilising 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 various programmes of planned development the resources had to be mobilised through various sources including public borrowing. The increasing amount of resources that were mobilised by the government through domestic or internal borrowing resulted in significant 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 15.1  
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	0048	0055
1984-85	0801	0039	0151	0953	0046	0061
1985-86	1193	0045	0182	1375	0052	0088
1986-87	1462	0059	0203	1665	0057	0076
1987-88	1723	0052	0232	1956	0059	0067
1988-89	2041	0052	0257	2298	0058	0079
1990-91 R.E.	2796	0060	0318	3114	0067	0106
1991-92 (Bu)	3181	0061	0356	3537	0074	—

Source : *Financial Express*, 11th August, 1991.

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 by 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 many developmental projects. Retirement of the internal debt, therefore, calls for a gigantic transfer payment whereby Indian individuals and business houses would pay higher taxes and the government, in turn, would pay out those 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 different. 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. Therefore, 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. Thus, 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 during 1980-91. Growing 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 terms and 10% in terms 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 almost 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 terms 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.

During the decade 1979 and 1989, as a proportion of GNP, external debt rose from 11.9% in 1979 to 24% in 1989. Not only this, the average rate of interest of external borrowings, which was 2.5% during 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% during the year and thus India has become the third most indebted country in the world after Brazil and Mexico. This huge 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 fulfil 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 basic 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 making serious efforts at promoting exports, all its efforts are getting a setback by the increasing imports. It is, therefore, imperative that a screening of imports be carried out and non-essential imports slashed with an iron hand. The philosophy of import led growth should be abandoned in favour 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 of import substitution or export promotion. But the flow of NRI deposits can

certainly mitigate the present foreign exchange scarcity. Another suggestion is to permit direct foreign investment by 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.

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

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## **15.7 ROLE OF RESERVE BANK OF INDIA IN PUBLIC DEBT MANAGEMENT**

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The Reserve Bank of India and its various 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 growing levels of output and employment on the one hand and stability in the price levels on the other. More specifically, monetary policy entails achieving two inter-related goals. First, it must expand the supply of money in the long run to meet the demand for money in a growing economy and, second, it must adjust the money supply to curb economic fluctuation, i.e., during recession to stimulate spending and, conversely, restrict the money supply during inflation to constrain spending.

The Reserve Bank of India as the central monetary authority has an important 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 certain 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 important step towards rationalisation of the interest rates structure was taken by 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 advances, 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 thus regulates the banking structure through imposition of such liquidity restrictions regarding credit supply.

Large public debt imposes constraint upon effective monetary (interest rate) policy. The basic dilemma is between 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, during periods of inflation, the monetary authority should restrict money supply which will raise interest rates and thereby tend to limit spending.

### Check Your Progress 2

Note : i) Use the space given below for your answers.

ii) Check your answers with those given at the end of the unit.

1) What do you understand by the process of conversion of public debt?

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2) Explain the term Sinking Fund. What are its advantages?

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3) Discuss the negative consequences of public debt.

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## 15.8 LET US SUM UP

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Public borrowing apart from imposition of taxes and deficit financing, is one of the methods through which resources are mobilised for taking up developmental tasks in the country. In this unit we have discussed the meaning of public debt, causes for increasing public debt which include increasing government outlays in public sector projects, for meeting temporary and short-term budget deficits etc. There are various types of public debt which can be categorised broadly into reproductive and unproductive, voluntary and compulsory, internal and external, short-term and

long-term. We have also discussed the importance of public debt management, its elements which include refunding, conversion, surplus budget, sinking fund etc. The unit has also touched upon the aspect of public debt, its impact on economic development and inflation. There has been significant growth of internal debt from Rs. 2054 crores in 1950-51 to Rs. 183, 183 crores in 1990-91. Similar is the position with regard to India's external debt. These aspects relating to trends and structure of public debt in India have been discussed. The Reserve Bank of India as the central monetary authority in the country has a very important role to play in public debt management which has been dealt with in the unit.

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## 15.9 KEY WORDS

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**Compulsory Deposit Scheme :** This was introduced for the first time in India in 1963-64 and reintroduced again in 1974. The Act provided for compulsory deposit for a period of two years of 50% of the additional dearness allowance and for one year of additional wages and salaries. All the employees of Central and State governments, local bodies, companies, corporations, industrial, commercial establishments in the private and public sectors, besides salaried employees who are liable to pay income tax were covered under the scheme.

**Cash Reserve Ratio (CRR) :** This is a general credit control method under which each commercial bank is statutorily required to maintain a certain minimum of cash (exclusive of the balances with the central bank of the country, viz., the Reserve Bank) a certain percentage of the bank's aggregate demand and time liabilities at the close of every business day.

**Crowding out effect :** An increase in government expenditure that has the effect of reducing the level of private sector spending. In a broader sense, it denotes the effect of larger governmental expenditure, leaving less for private consumption, spending, private sector investment and exports.

**Debt servicing :** In simple words it means payment of interest on debts that are due. It includes the cost of meeting interest payments, regular repayments of principal on a loan along with any other charges that are to be borne by the borrower.

**Debt trap :** It is a situation when a country is unable to meet the instalments of debt repayments and interest charges and it is forced to borrow again to repay old debts.

**Differential Rate of Interest (DRI) :** The scheme introduced by the Government of India in 1972 based upon the recommendations of a Committee appointed by the Reserve Bank of India under the Chairmanship of R.K. Hazari. This scheme was introduced to help the weaker sections of the society to raise their standard of living by undertaking productive self employment projects. Under the scheme, bank finances to the weaker sections are made available at rates lower than the general rate of interest.

**Devaluation :** It is the action taken by government of any country, reducing the valuation of its currency in terms of other countries, either by fixing its exchange value at a lower level or by allowing it to be depreciated by market forces. It is mostly used to correct a serious balance of payments deficit i.e. when import values far exceed export values and there is an increasing shortage of foreign exchange to pay for the imports. Such deficit is reduced by undertaking devaluation which lowers the price of exports in terms of foreign currencies and raises the price of imports at home.

**Great Depression :** The worldwide depression that started in 1929 and lasted till 1935. It was characterised by low economic activity and mass unemployment.

**Gross Domestic Product :** The total value of goods and services that are produced within a country over a specified period, usually one year, excluding all those goods and services used during that period to produce further goods and services.

**Gross National Product :** It refers to a comprehensive measure of a nation's output i.e. sum total of goods and services produced in the country during the year.

**Statutory Liquidity Ratio (SLR) :** According to the Banking Companies (Amendment) Act, 1962, all commercial banks are required to maintain a certain percentage of their time and demand liabilities with the Reserve Bank of India which is called Statutory Liquidity Ratio.

**Time and demand liabilities :** Time liabilities are fixed deposits which are withdrawable after specified periods. This includes deposits which are made for three months, six months, one, three years or more. Demand liabilities include those deposits which can be withdrawn by the depositor without previous notice to the bank.

**Treasury bills :** It is a financial security issued by the government as a means of borrowing money for short periods of time like three months.

**Ways and means advances :** These are short-term loans made by the central bank of the country to the government.

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## 15.11 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

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### Check Your Progress 1

1) Your answer should include the following points :

The causes for public debt include :

- Sharp increases in government outlays in public sector projects.
- Building up the economic infrastructure like railways, roads, power plants etc. which require huge investments.
- Lending of significant amounts of capital funds by the Central and State governments to the private sector for investment in planned development projects.
- For meeting temporary as well as long-term budgetary deficits.

2) Your answer should include the following points :

- Reproductive debts are those which are incurred by the government for the construction of such capital assets that yield revenue to the government like railways, irrigation projects etc. Here the income derived from the creation of such assets is used to repay the debt.

In case of unproductive debt, no asset is created. These debts are incurred to cover budgetary deficits or for such purposes as do not yield any income to the government like in case of wars.

3) Your answer should include the following points :

- Internal debt comprises loans or securities floated by the government and subscribed by persons or institutions within the country.
- External debts are those incurred when borrowing is resorted to from persons or institutions outside the country.

### Check Your Progress 2

- 1) Your answer should include the following points :
  - Conversion is one of the ways adopted for retirement of public debt. It implies changing the existing loans before maturity into new loans with change in rates of interest. This process generally alters a public debt from higher to a lower rate of interest.
- 2) Your answer should include the following points :
  - A sinking fund is a fund created by the government. Every year a part of the current public revenue is deposited in the fund with a view to paying off the funded debt at the time of maturity.
  - Creation of sinking fund minimises the aggregate burden of public debt as the task of taxing the people for resources is spread evenly over a period of time.
  - This inspires confidence among lenders and credit worthiness of the government increases.
- 3) Your answer should include the following points :
  - Imposition of extra taxes to finance the interest payments.
  - Decline in investment leading to loss of output.
  - Crowding out effect with reduction in private investment.
  - Possession of bonds by the people raises their consumption and reduces savings.



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## **UNIT 16 FINANCIAL APPRAISAL**

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### **Structure**

- 16.0 Objectives
- 16.1 Introduction
- 16.2 When to Undertake a Financial Analysis?
- 16.3 How to Value Project Benefits and Costs in a Financial Analysis?
- 16.4 The Cash Flow in the Financial Analysis
- 16.5 Discounting in Project Analysis
- 16.6 Let Us Sum Up
- 16.7 Key Words
- 16.8 References
- 16.9 Answers to Check your Progress Exercises

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### **16.0 OBJECTIVES**

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After reading this unit, you should be able to:

- understand the meaning of financial appraisal;
- highlight the need for a financial analysis; and
- explain the methodology of financial analysis.

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### **16.1 INTRODUCTION**

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Financial appraisal is a method used to evaluate the viability of a proposed project by assessing the value of net cash flows that result from its implementation. Financial appraisals differ from economic appraisals in the scope of their investigation, the range of impacts analysed and the methodology used. A financial appraisal essentially views investment decisions from the perspective of the organization undertaking the investment. It therefore measures only the direct effects on the cash flow of the organisation of an investment decision.

By contrast, an economic appraisal considers not only the impact of a project on the organisation sponsoring the project, but also considers the external benefits and costs of the project for other government agencies, private sector enterprises and individuals-regardless of whether or not such impacts are matched by monetary payments.

Financial appraisals also differ from economic appraisals in that:

- market prices and valuations are used in assessing benefits and costs, instead of measures such as willingness to pay and opportunity cost;
- the discount rate used represents the weighted average cost of debt and equity capital, rather than the estimated social opportunity cost of capital; and
- The discount rate and the cash flows to which it is applied are usually specified on a nominal basis as the cost of debt and cost of equity are observed only in nominal terms.

A financial analysis of a project is undertaken to assess whether it will be commercially profitable for the enterprise implementing it. A private firm will undertake a financial analysis of a potential investment in order to determine its impact on the firm's balance sheet. Governments and international agencies will also routinely undertake a financial analysis, as well as an economic analysis, of any project in which the output will be sold and a financial analysis will therefore

have some meaning. In this unit we will be discussing the meaning, the need and methodology of financial appraisals.

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## **16.2 WHEN TO UNDERTAKE A FINANCIAL ANALYSIS?**

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A financial analysis must 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 almost 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 example, the Department of Telecommunication offers provision of telephone services at a reduced rate, it needs to examine 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 between alternative facilities on the basis of essentially financial objectives. For example, 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 defence force will often choose between available alternative methods of achieving a physical goal, such as airborne troop management capacity, on the basis of the cheapest financial option. This procedure is called 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 terms of some quantitative target, such as the number of patient beds to be provided or number of troops that can be moved.

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

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The financial benefits of a project are just the revenues received and the financial costs are expenditures that are actually incurred by 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 include capital costs, the cost of purchasing land, equipment, factory building, 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 therefore measured in market prices. Market prices are just the prices in the local economy, and include 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 important to know whether the input and output projections given by the proposing firm or agency are valued in current prices (normal) or constant prices (real). This is necessary to ensure that the analysis is carried out in a consistent 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 by 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 make 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 increase at approximately the same rate over the life of the project.

However, there are several 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 terms to ensure that planned sources of finance will be sufficient 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 carried out in both nominal and real terms 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 requirements will also be affected by the level of inflation. Finally, if input prices are expected to rise at different rates over the life of the project, and vary from year to year, it will usually be simpler to include all prices in current terms.

- **Internal Transport and Handling Costs**

It is important 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 remember 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 therefore 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 include the transport and handling cost of getting them there.

- **Local and Foreign Costs**

Many a times project appraisals split costs (and sometimes benefits) between 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 agents such as aid agencies or multilateral banks wish to see the distribution of items eligible for aid grants or loans.

Usually, even if local and foreign costs are identified, in a financial analysis all costs and benefits are then expressed in local currency, converted at the official exchange rate. However, the foreign currency costs may in some instances be expressed in a common international currency like US Dollar, or in terms 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 make 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 partners. If local inflation is expected to be higher than the average for major trading partners, devaluation of the local currency could be anticipated, increasing 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 following section paragraphs discusses about how the inputs and outputs of a project that are valued in market prices should be incorporated into a project's cash flow in order to undertake a financial analysis.

### Check Your Progress 1

**Note:** i) Use the space given below for your answers.  
ii) Check your answers with those given at the end of the Unit.

- 1) Discuss when to undertake the financial analysis.

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- 2) Highlight how to value project benefits and cost in a financial analysis.

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## 16.4 THE CASH FLOW IN THE FINANCIAL ANALYSIS

It comprises the following input and output components:

- **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 by 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 must 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 process 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 maximise its return to the project implementer. The project's life is frequently set equal to the technical life of the equipment used. However, various 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 example, 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 included in the cash flow until it must be paid for by 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 terms 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 difference between start-up costs under capital costs, and steady state operating costs will be included as true operating costs.

- **Treatment of Taxes**

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 by 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 by the project from the sale 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 example, bank deposits, the sale of fixed assets or insurance claims, will also be included as separate items under project receipts or benefits.

- **Net Benefits**

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

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## 16.5 DISCOUNTING IN PROJECT ANALYSIS

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In project analysis, any costs and benefits of a project that are received in future periods are discounted, or deflated by some factor,  $r$ , to reflect their lower value to the individual (or society) than currently available income. The factor used to discount future costs and benefits is called the discount rate and is usually expressed as a percentage.

For example, suppose the project is expected to yield a stream of benefits equal to  $B_0, B_1, B_2, \dots, B_n$  and to incur a stream of costs equal to  $C_0, C_1, C_2, \dots, C_n$  in years 0, 1, 2, ...  $n$ . Then in each period the net benefits (benefits minus costs) of the project will be:

$$(B_0 - C_0), (B_1 - C_1), (B_2 - C_2), \dots (B_n - C_n)$$

This is simply 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:

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

Once future net income streams have been discounted in this way, expenditures and revenues from all the different 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 called the project's net present value, NPV. For, the previous example, the project's NPV is:

**Table 1: Manual Discounting of a Railway Project Cash Flow (\$L Million)**

Year (t)	1 Costs	2 Benefits	3 Net Benefits	4 Discount Factor $1/(1+0.08)^t$	5 Net Benefits
0	100	00	-100	1	-100
1	400	50	-350	.925	-24.1
2	200	150	-50	.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
<b>Total</b>	<b>1100</b>	<b>1550</b>	<b>4450</b>		<b>NPV=10.4</b>

The net present value criterion of a project is the single most important 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 by just adding up these discounted net benefits. Columns (1), (2) and (3) show the non-discounted costs, benefits and net benefits (benefits-costs) of the railway project. Column (4) gives the discount factor,  $1/(1+0.08)^t$ , by 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 indicates that the discounted benefits of the project are expected to be greater than its discounted costs and the project will therefore be worth undertaking.

This example 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 by 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,

possibly changing it from positive to negative. The selection of the appropriate discount rate is therefore a very important 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 therefore 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 investible 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 by the enterprise. If the project implementer intends to draw some funds from its own financial resources and some from market borrowings, the weighted cost of the capital it obtains from these different 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 therefore be the after tax market lending rate that it could earn on this capital. The project must earn at least this market lending rate for it to be worth doing and the after-tax lending rate should therefore be used as the financial discount rate for any project appraisals undertaken by this enterprise. In reality the enterprise will usually want to earn some margin above the market lending rate if the project is considered a riskier use of the firm's funds than available financial investments.

- **Discounted Project Assessment Criteria**

The two most 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 discussed below:

- a) **Project Net Present Value (NPV)**

The NPV measure of project worth is the most useful and one of the most commonly used criteria for determining whether a project should be accepted. The net present value of a project is simply the present value, PV, of its net benefit stream. It is obtained by discounting the stream of net benefits produced by 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,

B<sub>t</sub> are project benefits in period t

C<sub>t</sub> 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 1, the NPV of a railway project was estimated mechanically. The net benefits of the project each year were deflated by a factor equal to  $1/(1+r)^t$ , 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.

### b) The Internal Rate of Return of a Project (IRR)

The internal rate of return, IRR, of a project is probably the most 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 therefore 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 make the project's net present value equal to zero. Thus the internal rate of return is the discount rate,  $r^*$ , at which:

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

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 therefore 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.

### c) The Net Benefit Investment Ratio (NBIR)

The net benefit investment ratio, NBIR, is the most 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 by:

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

Where

OC<sub>t</sub> are the project's operating costs in period  $t$   
 IC<sub>t</sub> are the project's investment costs in period  $t$   
 B<sub>t</sub> are the benefits in period  $t$   
 $r$  is the appropriate discount rate

The NBIR therefore 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 completely compatible with those for the net present value and the internal rate of return of a project.

#### d) The Benefit Cost Ratio (BCR)

The benefit cost ratio was the earliest discounted project assessment criterion to be employed. However, due to problems associated with its applied use, it is rarely used in project appraisal today.

The benefit cost ratio is simply 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:

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

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.

#### Check Your Progress 2

**Note:** i) Use the space given below for your answers.  
ii) Check your answers with those given at the end of the Unit.

1) Briefly discuss cash flow in financial analysis.

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2) In order to appraise a project by NPV, what are the methods to be followed?

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### 16.6 LET US SUM UP

Governments and individuals can usually pursue only limited objectives when they choose projects on the basis of a financial appraisal. In most circumstances, a financial analysis using market prices to value a project's inputs and outputs will merely tell the analyst whether a project will be financially profitable. These

market prices usually contain many distortions such as taxes, tariffs and price controls and do not reflect the true costs and benefits to the economy of a project's use of particular inputs and production of various outputs. Therefore a financial analysis will only rarely measure a project's contribution to the community's welfare.

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## 16.7 KEY WORDS

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**Economic or Social Appraisal:** A process of judging the economic or social profitability of a project.

**Financial Appraisal:** A process of judging the commercial viability/profitability of a project.

**Managerial Appraisal:** A process of judging the integrity and competence of promotion and management team behind the project.

**Project Appraisal:** A process of judging the acceptability or otherwise of an investment project.

**Technical Appraisal:** A process of judging the technical feasibility of a project.

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## 16.9 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

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### Check Your Progress 1

1) Your answer should include the following points:

- A financial analysis must be undertaken if it is necessary to determine the financial profitability of a project to the project implementer.
- Financial analysis can be carry out if the output of the project can be sold in the market, or otherwise valued in market prices.
- This analysis can be carryout if the output of the project can be sold in the market, or otherwise valued in market prices.
- This analysis can be applied for a private sponsored project, and to a extent it can be also apply to some government business undertaking.
- Commercially oriented government agencies that are selling output will usually undertake a financial as well as an economic analysis of any new project they are considering.

- 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.

**2) Your answer should include the following points:**

- The financial benefits of a project are just the revenues received and the financial costs are expenditures that are actually incurred by 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.
- In a financial analysis, all these receipts and expenditures are valued as they appear in the financial balance sheet of the project, and are therefore measured in market prices.
- It is obviously very important to know whether the input and output projections given by the proposing firm or agency are valued in current prices (normal) or constant prices (real).
- It is important to be clear about where inputs and outputs should be priced in a project appraisal.
- Some project appraisals split costs (and sometimes benefits) between 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 agents such as aid agencies or multilateral banks wish to see the distribution of items eligible for aid grants or loans.

**Check Your Progress 2**

**1) Your answer should include the following points:**

- The financial cash flow of a project is the stream of financial costs and benefits, or expenditures and receipts, which will be generated by 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 must 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.
- Early in the process 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 maximise its return to the project implementer.

- 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.
- 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.
- 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.
- The project's net benefit stream is calculated as the difference between the total revenue (or benefit) stream and its expenditure (costs) stream.

2) Your answer should include the following points:

- The two most commonly used discounted measures of a project's net benefit are its Net Present Value (NPV) and Internal Rate of Return (IRR).
- The NPV measure of project worth is the most useful and one of the most commonly used criteria for determining whether a project should be accepted.
- The net present value of a project is simply the present value, PV, of its net benefit stream. It is obtained by discounting the stream of net benefits produced by 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,

$B_t$  are project benefits in period  $t$ ;

$C_t$  are project costs in period  $t$ ;

$r$  is the appropriate financial or economic discount rate; and

$n$  is the number of years for which the project will operate.

## **Structure**

- 17.0 Objectives
- 17.1 Introduction
- 17.2 Role of Cost Benefit Analysis in Project Development, Evaluation and Implementation
- 17.3 Financial Analysis and Economic Analysis: Distinction
- 17.4 Steps in Preparing a Full Economic Evaluation
- 17.5 Social Cost Benefit Analysis
- 17.6 Let Us Sum Up
- 17.7 Key Words
- 17.8 References
- 17.9 Answers to Check Your Progress Exercises

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## **17.0 OBJECTIVES**

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After reading this unit, you should be able to:

- highlight the need for an economic analysis by governments;
- discuss the role of Cost Benefit Analysis in project development, evaluation and implementation;
- bring out the differences between financial and economic analysis;
- explain the steps in preparing a full economic evaluation; and
- discuss the purpose of social cost benefit analysis.

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## **17.1 INTRODUCTION**

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An economic analysis, also called a cost benefit analysis, is an extension of a financial analysis. An economic analysis is employed mainly by governments and international agencies to determine whether or not particular projects or policies will improve a community's welfare and should therefore be supported. As cost benefit analysis enables the analyst to determine if a project will make a positive contribution to the welfare of a country, it should routinely be undertaken to evaluate major government-funded projects and policies. The government should also undertake a cost benefit analysis of any private project seeking government subsidies or policy support, such as tariff protection.

While a financial analysis is concerned only with the interests of the implementing agency or firm, cost benefit analysis is concerned with welfare of all the firms, consumers and government in a particular country. An economic analysis is not, however, concerned about the welfare of foreigners.

The methodology of cost benefit analysis, or CBA, was first developed in the 1930s in the United States when the Federal government had to decide whether to undertake many large, publicly funded irrigation, hydroelectricity and water supply projects in the dry central and western states of the United States. However, modern cost benefit analysis theory and practice has evolved largely from path-breaking work by Little and Mirrlees, Dasgupta, Marglin and Sen in their UNIDO Guidelines, Harberger, Corden, Squire and Van Der Tak and other work collected in Layard. Many other useful contributions have been made by various authors.

When a cost benefit analysis is undertaken, micro economic, macro economic and international trade theory is applied to real world situations in order to answer questions such as these:

- Should a new bridge be built, or should the existing ferry service be upgraded?
- Should an export-oriented aluminum refinery be established, or should the unprocessed bauxite and coal be exported?
- Should computers be imported or assembled locally?
- Will this irrigation project be a better use of resources and lead to a greater increase in community welfare than that highway project?
- What fuel should be used to generate electricity?

For the government to answer these questions, it is necessary that it goes beyond a financial appraisal, which determines how commercially profitable these alternative policies and potential investments would be. This is essential for a number of reasons. The first is that governments typically have broader and more complex objectives, which they wish to achieve from public good and social service provision and policymaking generally, than mere profit maximisation. If governments only wished to maximise profits from the operation of state enterprises, they would be well advised to privatise them, as the private sector is likely to be more efficient at pursuing this goal. Government objectives fall broadly under the heading of "optimisation of community welfare". The most straightforward economic objective is the optimisation of the level of GNP per capita. Other objectives may include preserving the environment, redistributing income to particular target groups or regions and enhancing national security. Even from this short list it is obvious that there may be conflict between some of these objectives. One of the major reasons that governments use cost benefit analysis is to determine the impact of various competing projects on community welfare, defined in terms of all these different criteria.

The other major reason for the use of cost benefit analysis lies in the many distortions and imperfections that affect prices in factor and goods markets. In many countries market prices, that is, prices quoted in domestic markets, reflect a range of distortions, including taxes, subsidies, controlled prices, tariffs, and monopoly or monopsony rents. These factors distort market prices so that they no longer reflect the true economic value that people place on consuming such goods and services (their demand price), or the true cost to the economy of producing them (their supply price). If a government wishes to determine which projects will make a positive contribution to community welfare, it will not necessarily be able to use the market prices of the projects' inputs and outputs to calculate their true costs and benefits to society.

When undertaking a cost benefit analysis, the project analyst will try to correct for such distortions by calculating economic, or shadow, prices. The shadow prices of the project's inputs and outputs, like labour and capital, goods that enter international trade, traded goods, and those that do not, non-traded goods, will reflect the true economic value of these inputs and outputs to the economy concerned. In a cost benefit analysis shadow prices for projects' inputs and outputs are substituted for market prices.

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

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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:

- **Project Identification**

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 include the provision of health, transport or education services, for example. The first major issue that must be investigated is the existence of market opportunities. In the case of social services, the analyst must 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 many 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 process yields the basis concept of the project and background information, which enables the government to progress to the pre-feasibility study stage.

- **Pre-feasibility Study**

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 must be made of the demand for the project's output, the technical capacity and cost of the plant or technology envisaged, and the project's manpower requirements. In many cases this data will be provided by 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 by 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 study stage.

- **Feasibility Study**

At this stage, more accurate data must be obtained on all project costs and benefits, but particularly those that risk analysis indicates 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 phase.

- **Project Design**

This involves undertaking the detailed engineering design work of the project, based on the technology envisaged at the feasibility stage. Manpower requirements, administration and marketing procedure are all finalised 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 possibly the operation of the project.



- **Ex-post Evaluation**

The final stage of a project is essential, yet frequently overlooked in project appraisal and implementation. This evaluation is designed to determine the actual contribution that the project has made to national welfare, after several 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.

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### **17.3 FINANCIAL ANALYSIS AND ECONOMIC ANALYSIS: DISTINCTION**

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The economic analysis technique outlined above have much in common with financial analysis. However there are significant 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. Thus, a proposal put forward by 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 must be taken into account. Similarly, a strictly financial analysis does not consider the opportunity cost of using resources in the case where the actual price paid by or to the entity is not a good indicator of the real value in terms 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 by the use of a discount rate.
- **Thirdly**, in economic analysis capital expenditure is recognised as a resource cost at the time it is incurred whereas in financial analysis it may be shown amortised over the life of the project for taxation and other purposes.

In the public sector the fundamental requirement is for an economic appraisal. However 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- an important factor when managing the State's finances. It will also show the rate of return from the project which is important for commercial agencies.

There is an important distinction between the costs and benefits involved in a financial analysis and those included in an economic analysis.

Financial analysis whether used in the public or the private sector, implies the notion of the agency maximising its net financial surplus over time. This will generally differ from the maximisation 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 between financial appraisal and economic evaluation will commonly be comparatively small. However for agencies with significant community service obligations, financial appraisal can be suitably applied only in a narrow range of decision choices. Thus in the economic evaluation of a public road not subject to a toll, financial appraisal will not be of much assistance. Similarly, in choosing between two sites for a hospital, not only should the costs of building on the two sites be

considered, but also the level of transport costs and length of travel time incurred by patients and visitors to the hospital.

Thus 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 generally have to consider a wider range of costs and benefits than occurs in a financial appraisal.

### Check Your Progress 1

**Note:** i) Use the space given below for your answers.  
ii) Check your answers with those given at the end of the Unit.

- 1) Highlight the role of cost benefit analysis in the project development, evaluation and implementation.

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- 2) Discuss the differences between financial analysis and economic analysis?

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## 17.4 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 many ways the most crucial aspect 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 process. One alternative that should be considered is the possibility of the objective being met by the private sector. In developing various options the first option to be considered 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 many cases doing nothing (for example 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 continued 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 basic principle of any type 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 existence. 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 important implications:

**First,** economic evaluation must not simply be a comparison of before project conditions with after project conditions because such comparison would attribute the contribution of all pre-existing trends and external factors to the project itself. For example, 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 include all impacts, both beneficial and otherwise, of the proposal being evaluated. In particular, not only should the intended effects or benefits which are the objectives of the project be included, but also the subsidiary or indirect effects.

There are a range of types of benefits and costs which must be considered, and they accrue to different people: some accrue directly to the user or provider of the service; while others accrue to outsiders (these are known 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 example. The impacts to be included 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 by 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 difficult to quantify even in physical terms).

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.
  - i) Costs and benefits which can be readily identified and valued in money terms (e.g. Value of additional electricity supplies to users, travel time savings).

- ii) Effects which can be identified and measured in physical terms but which cannot be easily valued in money terms because of the absence of market signals and consequential disagreement as to the rate of valuation (e.g. museums, reduction in pollution).
- iii) Impacts which are known to exist but cannot be precisely identified 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.

- a) **The Opportunity Cost Principle:** The use of resources (manpower, finance or land) in one particular area will preclude their use in any other. Hence the basis for valuing the resources used is the "opportunity cost" of committing resources; i.e. the value these resources would have in the most attractive alternative use.

The adoption of this principle reflects the fact that the economic evaluation of public sector projects should be conducted 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 resources. The position may be less clear in the case of the existing land owned by the agency. However, in general it is considered 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 different from its market value. For example, 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.

- b) **Willingness-to-pay Principle:** In valuing the benefits of a project the aim is to place a monetary value on the various outputs of the project. Typically such outputs will include:

- i) benefits for which a price is paid; and
- ii) benefits for which no price is paid.

Where the services are bought and sold it is generally presumed that the price paid is a reasonable proxy for the values of the service to the consumer. This principle will hold most closely where the changes in output and price levels associated with the investment are relatively small. Where output changes are significant 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). However, 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 variety of techniques are available including:

- i) the use of data on expenditure by consumers in seeking to participate in benefits (e.g. costs incurred in visiting a national park);

- ii) price data from related goods and services (e.g. variations in house prices due to the impact of noise levels to assess the cost of airport noise); and
- iii) choice experiments (e.g. experimental choice between a variety of existing and new amusement/recreation amenities to infer a value for a new amenity).

Where no established framework exists, valuation of non-traded outputs will have to be approached on a case by case basis.

Some government services have been provided at subsidised prices and this introduces distortions in the market. Therefore 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**

- a) **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 example, the construction of a dam may increase the value of the land which is to be irrigated as a result of the increased ability of the land to grow crops. The increased value of the land merely reflects the market's capitalisation 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 by attributing the total output of a process to a single input. In the above example, the total value of the crops made available by the water irrigation project should not be attributed to the project. Rather the net value of the additional production should be derived by deducting all additional input costs from the value of the additional output, i.e. the costs of labour, capital and other inputs such as fertiliser 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 provides 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.

- b) **Treatment of Inflation**

Due to inflation, costs and benefits which occur later will be higher in cash terms than similar costs or benefits which occur earlier.

There are two different 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 by a real discount rate. In practice it is considered that the use of real cash flows and discount rates may simplify the forecasting and calculation processes.

- c) **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 unpriced gains and losses that it is expected to

generate. He will, for example, add to the cost of a factor or subtract from the cost of a good, in making 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. Certain 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 must value at its opportunity cost; not at its wage; and so on.

#### **d) Valuation of Specific Cost Items**

##### **i) Land and Pre-existing Buildings/Plant**

While a project may use land, buildings or plant already owned by an agency for which no payment will be made, the opportunity costs of these assets should be included.

##### **ii) Labour**

In assessing labour costs, the value of existing labour resources transferred to the project, as well as additional labour required, should be included.

##### **iii) Overheads**

Labour related overheads such as supervision, transport costs, administrative costs, printing and stationery etc., are also included.

##### **iv) 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 level 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 included in the evaluation. Certain 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 included as costs in accounting reports or financial appraisals should not be included in an economic evaluation of an investment proposal.

##### **a) Sunk Costs**

In an evaluation, all costs must 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 terms of today's value (or price) which must be included. All past or sunk costs are irrelevant and should be excluded.

##### **b) 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 is 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 included in the economic evaluation.

**c) Interest**

As future cash flows are discounted to present value terms in economic evaluations, the choice of the discount rate is based on various factors which include the rate of interest. The discounting process removes the need to include interest rate in the cash flows.

• **Discounting of Future Costs and Benefits**

**a) 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 existence 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 by discounting the value of future costs and benefits in order to determine their present value. The process of discounting is simply compound interest worked backwards.

**b) The Recommended Discount Rate**

Private sector entities sometimes require that the rate of return on a particular 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 resources used in the public sector investment projects. Resources 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. However, for various 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.

Resources devoted to public investment will be at the expense of current consumption or private sector investment. In a growing 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 level. This so-called **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 resources might earn (before tax) in the private sector (the so-called **marginal social opportunity cost**).

This concept is also difficult 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 by 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 provide 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.

### c) **Impact of Discount Rates on Project Ranking**

It should be noted that the choice of the discount rate is an important issue as it can have a significant 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. Thus, a higher discount rate would favour maintenance options as against asset replacement.

Similarly 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 terms relative to net benefits closer to hand.

Thus, short lived options are favoured by higher discount rates relative to long-lived options.

### d) **Decision Criteria**

Once all the costs and benefits over the life of the programme have been identified and quantified, they are expressed in present value terms.

Using the discounted stream of costs and benefits, the following decision measures should be calculated. Investment decision making is primarily concerned with three types of processes:



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

Various investment criteria are available 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).

#### 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; ie 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.

#### ii) 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 terms it can be expressed as follows:

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

A project is potentially worthwhile if the BCR is greater than 1; ie, 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 types when calculating BCRs: initial capital costs and ongoing costs. Ongoing costs are normally deducted from benefits in the year incurred to make a net benefit stream, while initial capital costs are used as the denominator.

#### iii) 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, ie discounted benefits equal

discounted costs. In algebraic terms the IRR is the value of  $r$  which solves the equation:

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

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.

#### iv) Evaluation of Decision Rules

The NPV and BCR provide 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 conflict with each other.

While in many 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 different IRR may be calculated. An example of a non-conventional cost-benefit stream is where a project incurs net costs initially followed by net benefits over a number of years and then net costs again.

#### v) Choice between Mutually Exclusive Projects

A simple use of NPV, BCR and IRR will not yield the same results for the more complex choice between 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 by the inclusion of costs as negative benefits, or different balances between initial costs and ongoing costs. This makes it difficult to compare across projects.

Where there are no constraints on inputs, such as capital resources, the choice between 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 provides the largest potential contribution to welfare is adopted.

#### vi) Ranking Under Constraints

In practice decision-makers operate in environments where constraints are commonplace. Indeed constraints on capital funds are almost universal. In order to ensure the Government's budgetary objectives are met, such constraints will clearly heavily influence decision making on projects. The problem facing decision-makers is to rank projects in terms of return to the constrained input and then choose projects so as to maximise 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. However, 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:

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

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 available 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 various factors affect the overall cost or benefit of a given investment project.

A key practical role of sensitivity analysis is to incorporate different views about one or more key assumptions which can reasonably be held by the different people involved in the assessment process.

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 during project implementation or to divert further resources to the improvement of cost and benefit estimates and the reduction of uncertainty. (It is a necessary part of any investment appraisal.)

The steps in undertaking appropriate sensitivity tests are outlined below.

#### i) Decide plausible range of values for factors subject to uncertainty:

- e.g.
- real energy cost + or - 20 per cent
  - real wages + 4 to +12 per cent
  - exchange rate + 50 to -30 per cent

#### ii) Determine relationships between the sensitivities for the various variables (e.g. nominal wages and inflation). If correlations exist these may be tackled by:

- moving to a higher level of aggregation (e.g. consider the movement of real wages rather than nominal wages and inflation).
- looking at the underlying source of uncertainty.
- specifying a set of mutually consistent assumptions for relevant factors under a number of different scenarios.

- iii) Calculate the effect of plausible changes on the decision criterion (the NPV). The range of values taken by many variables may not be large enough to alter the decision and may therefore be eliminated, thus reducing the number of variables under consideration.

If sensitivity analysis is to be useful to decision-makers it needs to be undertaken systematically and presented clearly.

- **Post-Implementation Review**

A selection of the major projects undertaken by 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:

- i) re-evaluation of the benefits and costs of the selected option to assess whether the anticipated benefits were realised and the forecast costs kept to;
- ii) reconsideration of alternative options; and
- iii) examination of the project design and implementation to assess the scope for improvement to the option adopted.

By 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.

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## 17.5 SOCIAL COST BENEFIT ANALYSIS

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The financial or traditional economic project appraisals implicitly assumed that income distribution issues are beyond the concern of the project analyst or that the distribution of income in the country is considered appropriate. However, in many, if not most, developing and developed countries governments are not only interested in increasing efficiency but also in promoting greater equity. In most countries the existing distribution of income is clearly not considered to be ideal by 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 increase welfare once their distribution impact is considered. The project analyst is not only concerned to determine the level of a project's benefits and costs but also who receives the benefits and pays the costs. Social appraisal therefore tackles the moral and theoretical dilemma—that 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 by any individual will increase the community's welfare by the same amount as a dollar received by any other individual. However, an extra dollar given to a very poor person, with an annual income of say only USD300, will usually increase that person's welfare by 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 by USD100 per annum even if it reduces the consumption of rich people by USD50. On the other hand, the community may not be prepared to undertake another project, B, which increases the consumption

of the rich by USD100 and reduces that of the poor by USD50. The theoretical rationale in welfare economics for the social analysis of projects is therefore 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 most 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 by different 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 by all income groups are weighted at unity,  $d=1$ . In a social analysis income accruing to (or being taken from) lower income groups would typically be given a distributional weight greater than one ( $d>1$ ). On the other hand, income accruing to (or being taken from) a high income group would be given a weight less than one ( $d<1$ ). A project that benefits a low income group would therefore 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 example shown below the government of a country with a highly skewed income distribution is considering two mutually exclusive projects, A and B.

Table 1

### The Use of Distributional Weights in Social Analysis of Projects (\$L Million)

	Project A			Project B		
	Poor		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 by the rich and its benefits are received by the poor, while project B is the opposite. Its costs are borne by the poor and its benefits are received by the wealthy. Since the two projects are mutually exclusive the project with 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 \$180 and project A an NPV of \$150. Hence, project B should be selected. However, 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 example,  $d=2$  to the low income group's income, project A would have a social NPV of \$200 and project B would have a social NPV of \$10. 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 several problems for analysts wishing to use this approach. The first is the difficulty of tracing the net income changes accruing to different income groups as a result of the project, even in the case of relatively straightforward projects. It may be very time consuming and expensive to identify who will bear the costs of a project, who will reap its benefits; and what the income levels of these different groups are. It has therefore been argued that the introduction of distributional issues into project appraisal will so increase 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 levels may be difficult to determine. The counter argument put by 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 consistent 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 different 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, by necessitating comparisons of the welfare that individuals receive from increasing their income by a fixed amount, say \$1, social cost benefit analysis compromises the objectivity of project appraisal. Instead, Jenkins and Harberger recommend merely documenting 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 by different income groups within the framework of the project appraisal implies that the analyst gives equal weight to gains in consumption by all income groups, from the poorest and most 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 increase in consumption, of all individuals was equal irrespective of their income levels.

Another argument advanced by those opposed to the introduction of distributional issues into cost benefit analysis is that projects should be selected in order to maximise 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 many developing countries, however, 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 sufficient political resistance to making direct transfers to target groups through the fiscal system. The only acceptable method of making transfers may be via public sector projects to provide 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 available 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 example, in Australia it may appear reasonable that changes in consumption enjoyed by families on an income of less than \$A15000 should be given an income distributional weight of 2, and consumption changes by those on an income of more than \$A90000 should be given a distributional weight of 0.5. However, 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 therefore 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.

### Check Your Progress 2

- Note:** i) Use the space given below for your answers.  
ii) Check your answers with those given at the end of the Unit.

- 1) Briefly explain the steps in preparing a full economic evaluation.

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- 2) Highlight the purpose of social cost benefit analysis.

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## 17.6 LET US SUM UP

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Financial, economic and social analyses are flexible tools for assessing alternative uses of resources in order to achieve welfare objectives determined by the government.

A financial analysis indicates whether a project will be profitable to its implementer, by using market prices for inputs and outputs. An economic analysis, using shadow prices, reveals which projects will make a positive contribution to economic welfare. Finally, a social analysis extends an economic analysis, and includes an examination of the distributional impact of the project.

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## 17.7 KEY WORDS

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**Capital Market:** refers to various institutions and arrangements concerned with the purchase, sale and transfer of stock and bonds.

**Labour Economics:** Labour economics studies the demand and supply for the most important factor of production, human beings. Since the days of Marshall and indeed of Smith, if not earlier, economists have recognised that one cannot analyse the market of labour, without taking account of such issues as social relations of production, long term contractual arrangements, problems of effort and motivation, as well as institutions like unions and internal labour markets, which differentiate the labour market from a bourse. For many years recognition of these factors made labour economics an area in which economic theory was applied sparingly and in which institutional analyses dominated.

**Subsidies:** A payment made by a government to one or more firms to prevent an increase in the price of a product or to prevent the decline of a firm of industry.

**Tariffs:** A tax applied to imports either as a percentage of their value or on a unit basis.

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## 17.8 REFERENCES

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## 17.9 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

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### Check Your Progress 1

1) Your answer should include the following points:

- The initiating agency, such as government department or utility, defines the initial concept of project and outlines the objectives that government wishes it to achieve.



- Through pre-feasibility study financial and economic analysis of the project will be undertaken by the economic analyst, to determine whether the project appears to be financially and economically viable.
- The next stage of the study is the feasibility study. Here the financial and economic viability of the project is assessed again. If the project is still found to be viable, approval should be sought to proceed to the project design phase.
- The final stage of the project is ex-post evaluation. The primary purpose of this evaluation is to help to identify the major sources of project success and failure, so that future project development, analysis and operations procedures can benefit from the past experience.

**2) Your answer should include the following points:**

- The traditional financial analysis examines a project from the narrow prospective of the entity undertaking the project.
- In public sector the fundamental requirement is for an economic appraisal.
- The financial analysis will show the demand on cash flow which will result from the project an important factor when managing the states finances. The financial analysis will also show the rate of return from the project which is important for commercial agencies.
- Financial analysis whether used in public or private sector implies the notion of the agency maximising its net financial surplus over time.
- This will generally differ from the maximisation of the economic surplus generated for the community as a whole.
- In case of commercial agencies the difference between financial appraisal and economic evaluation will commonly be comparatively small.
- Agencies with significant community service obligations, financial appraisal can be suitably applied only in a narrow range of decision choices. For example the economic evaluation of a public road not subject to a toll, financial appraisal will not be of much assistance.

**Check Your Progress 2**

**1) Your answer should include the following points:**

- The steps involved in preparing a full economic evaluation are as follows:
  - i) The specification of the objectives of the proposal and their relation to the overall objectives of the agencies.
  - ii) To identify the widest possible range of action at the earliest stage of the planning process.
  - iii) An attempt should be made to estimate the 'state of the world' as it will exist with the project in existence.
  - iv) The next step will be valuation of cost and benefits.
  - v) There are certain things to be taken into consideration such as while enumerating the cost and benefits of a proposal, care should be taken to avoid double counting.
  - vi) Items which are included as costs in accounting reports or financial appraisals should not be included in an economic evaluation of an investment proposal.

- vii) The next step is the discounting of future cost and benefits. This is done by discounting the value of future cost and benefits in order to determine their present value.
- viii) Sensitive analysis is used to assess the possible impact of uncertainty.
- ix) A selection of major project undertaken by an agency should be subjected to ex-post evaluation.

**2) Your answer should include the following points:**

- Developing and developed countries are not only interested in increasing efficiency but also in promoting greater equity.
- Social cost benefits analysis or the social appraisal of the project as evolved to respond to this need.
- Social appraisal of a project goes beyond an economic appraisal to determine which project will increase welfare once their distribution impact is considered.
- The social appraisal tackles the moral and theoretical dilemma – that a project is worth undertaking if it has the potential to produce a Pareto improvement in welfare.

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# UNIT 18 LEGISLATIVE CONTROL

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## Structure

- 18.0 Objectives
- 18.1 Introduction
- 18.2 Concept of Legislative Control
- 18.3 Historical Background of Legislative Control
- 18.4 Provision in the Constitution, 1950
- 18.5 Control over Taxation
- 18.6 Control Over Public Expenditure—An Evaluation
- 18.7 Let Us Sum Up
- 18.8 Key Words
- 18.9 References
- 18.10 Answers to Check Your Progress Exercises

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## 18.0 OBJECTIVES

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After reading this unit, you should be able to

- explain the concept of legislative control
- describe the historical background and constitutional provisions of legislative control
- examine the extent of control exercised over taxation; and
- explain and evaluate the legislative control over public expenditure.

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## 18.1 INTRODUCTION

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Financial administration of a country is executed through (a) the legislature, (b) the Executive, (c) the Finance Department, (d) the Audit and (e) the Parliamentary committees. Legislature is the only competent organ of government in democracies which authorises the government to collect taxes and also to spend them in a particular manner. Without legislative approval neither the amounts can be appropriated nor taxes collected. It can also abolish or decrease or levy taxes. In theory it is the executive which demands and the legislature approves. Therefore, before the government can work on its budget plan, it has to get it passed by the Parliament. This is known as enactment of the budget.

The discussion on the budget in Parliament provides the members with opportunity to review, the working of various Departments and Ministries. It also enables them to elicit information on the progress achieved in the implementation of various programmes undertaken by the Government. The members get an opportunity of, examining the worthwhileness and the social and economic implications of the new expenditure proposals included in the budget.

After the budget is approved, the Appropriation Act is passed by Parliament authorising the executive to incur expenditure against the allotments included in various grants. Through the delegation of financial powers, the Ministry of Finance shares its responsibility for financial control with the administrative ministries during the implementation of the budget. The Legislative Control is exercised through the operation of the committees of Parliament, namely, the Public Accounts Committee, the Estimates Committee, the Committee on Public Undertakings, the Committee on Subordinate Legislation and the Committee on Assurances.

The Comptroller and Auditor General of India—a statutory authority under the Constitution—acts as a watch dog of the Parliament and conducts audit to see that

the expenditure incurred by the Executive is for the purpose voted by the Parliament and is within the sanctioned grants. The cases of default, financial irregularities misappropriation of funds and neglect of financial propriety are reported by the Comptroller and Auditor General of India to the Public Accounts Committee for such action as it may deem necessary. While examining the appropriation of accounts and the reports of the Comptroller and Auditor General of India thereon, the Committee conducts an elaborate system of investigations. The review of the Audit Report by the Public Accounts Committee completes the cycle of Parliamentary financial control over appropriation grants to the Executive.

The entire administrative machinery comes under the potential control of the legislature. This is because every action may provide a question; every question, an adjournment debate, and 'every adjournment debate a full-dress debate'. Besides, the Parliamentary Committees too, exercise control over the Government of the day.

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## 18.2 CONCEPT OF LEGISLATIVE CONTROL

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Parliament exercises control over revenue, expenditure, borrowing and accounts. Legislative sanction is required for the levy of new taxes or for the increase 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 scrutinised by the Public Accounts Committee and are audited by a statutory authority which is independent of the executive. In Indian context, the following four principles of financial control are being followed:

- i) The executive, acting through Ministers cannot raise money by taxation, borrowing or otherwise without the authority of Parliament; proposals for expenditure requiring additional funds must emanate from the cabinet.
- ii) The second principle is the Control that vests in the Lok Sabha which has the exclusive control of the Money bills. These must originate in the Lok Sabha which has the sole power to grant money by way of taxes or loans and to authorise expenditure. The Rajya Sabha may reject a grant but not add to it.
- iii) The demand for grants must 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.
- iv) Likewise, the proposal for a new tax or for an increase in the rate of an existing tax must 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.

**1) Question Hour :** The first hour of every Parliamentary day is reserved for questions, which provide an effective form of control. Questions asked can keep the entire administration on its toes. A question is an effective device of focusing public attention, in a striking manner, on different aspects of administration's policies and activities. Any administrative action can provoke a question, though the member cannot compel the Minister to give the answer. The Speaker, too, may disallow certain questions. A question is asked with a view to getting information, obtaining ministerial opinion on a subject or simply hammering the government on alleged weak points. Many 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 known, popular and commonly employed method of ensuring accountability. From time to time members have been raising matters of great importance through their questions.

**2) Adjournment Debates :** The device of adjournment motion is a tool of day-to-day control, and may be utilised for raising a discussion in the House on any specific question of urgent nature and of public importance. If allowed by the presiding officer, an immediate debate takes place on the matter raised, thus suspending the normal business of the House. In practice, it has been seen that the Speaker has shown a consistent tendency not to interpret the term 'urgent nature and of Public importance' liberally.

**3) Debates on Enactment of Acts and Amendments :** The various readings of a bill provide opportunities to the members of Parliament to criticise the entire policy underlying the bill. The criticism may even make the Government change its mind. The Government, for instance, withdrew the highly controversial Hindu Code Bill in 1951. Similarly, whenever Parliament is approached for the amendment in the Act, the members again get an opportunity to discuss the same.

**4) 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 various opportunities of discussing the budget, on the following occasions:

- a) 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.
- b) Voting on grants provides 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.
- c) Discussion on the Finance Bill provides an endless opportunity to discuss the entire administration. In the words of G.V. Mavlanker, "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 called upon to pay, unless he is given, through Parliament the fullest latitude of representing his views and conveying his grievances."

**5) President's Speech :** The President addresses both the Houses of Parliament assembled together at the commencement of the Budget session. The address is prepared by 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 criticise the entire realm of administration for its alleged acts of omission and commission.

**6) 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 by the Ministers from time to time, on the floor of the House and it reports on:

- i) the extent to which such assurances, promises etc., have been implemented and
- ii) where implemented, whether such implementation has taken place within the minimum time necessary for the purpose. The existence of such a committee makes Ministers more careful in making promises.

**7) Audit :** Parliament exercise control over Public expenditure through the Comptroller and Auditor General who audits all Government accounts to ensure that the money granted by 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 thus, secured

through the reports of the Comptroller and Auditor General who has rightly been described as the guide, philosopher and friend of the Parliament.

### Check Your Progress 1

Note : i) Use the space given below for your answers:

ii) Check your answers with those given at the end of the unit.

1) What is legislative control? Discuss the principles of financial control.

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2) What are the various instruments of exercising legislative control? Explain.

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## 18.3 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 collected from the king's domain. Hence the budget was a statement of revenue and expenditure. During 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 established. 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 during the reign of King John was towards the control of receipts and revenues rather than 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 significant historical developments in the arena of Legislative Control.

Thus 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.

## 18.4 PROVISIONS IN THE CONSTITUTION, 1950

The Constitution of India provides in its various 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 by the House of Parliament unless it has been agreed to by both Houses, either without amendment or with such amendments only as are agreed to by both Houses.

Article 109 (1) provides 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 by 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 by both the Houses with the amendments recommended by the Council of State and accepted by the House of the People.

Article 112 (1) provides 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 called "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) provides that as soon as the grants under Article 113 have been made by the House of the People, there shall be introduced a Bill to provide for the appropriation out of the Consolidated Fund of India of all moneys required to meet:

- a) the grants so made by the House of the People, and
- b) 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:

- a) to make 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.
- b) to make a grant for meeting an unexpected demand upon the resources 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;
- c) to make an exceptional grant which forms no part of the current service of any financial year, and the Parliament shall have power to authorise by 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 making 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 making such provision shall not be introduced in the Council of States. No such recommendation shall be required for moving an amendment making provision for reduction or abolition of any tax.

Article 117 (b) also provides that a Bill which, if enacted and brought into operation, would involve expenditure from the Consolidated Fund of India shall not be passed by either House of Parliament unless the President has recommended to that House the consideration of the Bill.

## Check Your Progress 2

- Note : i) Use the space given below for your answers.  
ii) Check your answers with those given at the end of the unit.

- 1) Trace the historical background of legislature control.

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- 2) Explain the various provisions as contained in the Indian Constitution as to legislative control over financial matters.

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## 18.5 CONTROL OVER TAXATION

Legislation of the Budget is by 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 includes all the existing taxation schemes with modification or without modification.

This practice is quite in consonance with the well known principle of democracy that "no tax shall be levied or collected except by authority of law", as embodied in Article 265 of our Constitution. So while the passage of the Appropriation Bill authorises the Government to appropriate money from the Consolidated Fund, the passage of the Finance Bill authorises 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 by the Parliament every year. It is open to general and clause by clause discussion. Amendments may propose the abolition or the reduction of any tax but may not propose new tax or an increase in the rate of any existing tax. The Bill as amended is passed by the Lok Sabha and after consideration by 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, therefore, the Lok Sabha that proceeds with Bill. The Finance Minister presents his annual financial statement to the Lok Sabha and the presentation is followed by 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 give vent to the grievances of the people.

A Money Bill, however, 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 by the Speaker of the Lok Sabha



- c) A Money Bill must be returned by 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 however, is resolved at a joint sitting by a majority of the total number of members present and voting.

## **18.6 CONTROL OVER PUBLIC EXPENDITURE—AN EVALUATION**

The function of the legislature does not end with the voting of grants for public expenditure. It 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 (1) 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 by the Comptroller and Auditor General of India followed by an examination of his report by a Parliamentary sub Committee.

Joint responsibility of the political executive to the Parliament is an essential feature of Parliamentary democracy. The most important control exercised by the Parliament over the executive is its control on the pursestrings. The executive can not spend any money without authorisation from the Parliament.

### **Audit by 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 by the executive for the purposes for which they were granted. This is ensured by the provision of audit of the accounts by 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 available 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 by 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 certain committees of the Parliament. Some important committees of this type 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 known as the Public Accounts Committee.

Rule 143 relating to Control of Committee on Public Accounts provides:

- 1) In scrutinising 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:
  - a) that the money shown in the accounts as having been disbursed were legally available and applicable to the service or purpose to which they have been applied or charged
  - b) that the expenditure conforms to the authority which governs it, and
  - c) that every re-appropriation has been made in accordance with the provisions made in this behalf in the Appropriation Act, or under rules framed by

- 2) It shall be the duty of the Committee on Public Accounts:
  - a) to examine 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.
  - b) 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 examine 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 by Government wherever necessary. Thus the Public Accounts Committee is the mechanism to secure the accountability of the executive in respect of expenditure voted by 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 by 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:

- 1) report what economies, improvements in organisational efficiency or administrative reform, consistent with the policy underlying the estimates may be effected,
- 2) suggest alternative policies in order to bring about efficiency and economy in administration,
- 3) examine whether the money is well-laid out within the limits of the policy implied in the estimates,
- 4) 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 makes the suggestions on organisations, economy etc. including policy matters.

#### **The Committee on Public Undertakings**

The examination of Public Undertakings by the COPU is in the nature of the evaluation of the performance of Public Undertakings covering important aspects 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 alongwith its own comments. The reports of this committee alongwith C.A.G.'s reports provide a very effective instrument of control of Parliament over Public expenditure.

#### **Parliament's Direct Control**

The Parliament exercises direct control over Public expenditure by examining the reports of the committee on Public Accounts and Estimates Committee. A general discussion is held on the reports submitted by 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:

- a) expenditure is according to the rules prescribed
- b) there is economy in expenditure, and
- c) there is no fraud, embezzlement or misappropriation.

- Note. i) Use the space given below for your answers.  
 ii) Check your answers with those given at the end of the unit.

- 1) Why is it considered necessary to control Public expenditure? Discuss the functions of Parliamentary Committees which control the budget.

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- 2) Discuss the role of Comptroller and Auditor General of India in controlling Public expenditure.

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## 18.7 LET US SUM UP

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Need for sound financial administration has become imperative because government expenditure has greatly increased. Financial administration is becoming complex day-by-day. It includes raising, spending and accounting of funds collected from the tax payers. The funds are needed by the executive, granted by the legislature, spent by the administrative ministries and audited by the Comptroller and Auditor General.

According to democratic principles, no tax can be levied or collected and no expenditure can be incurred by the government except with the prior consent of the Parliament. It is often argued that the control of the Parliament over the financial administration is more nominal than real. Requests for grants cannot be revised because they are presented by the executive, which represents the majority in the Parliament. However, it must be realised that the power of modifying the budget proposals of the Government may not be exercised but the very fact that the Parliament has this power gives it a great deal of authority over the executive.

Even if the budget proposals of the Government are not normally modified by the Parliament the budgetary process gives the members a number of opportunities to discuss the policy of the Government. During the general discussion on the budget the members can criticise the general policy of the Government and can suggest alternatives. During discussion over the grants of different departments, the Parliament can examine in detail the working of particular departments and make suggestions about improving their working. Similarly opportunities are also provided by discussions on the Appropriation Bill and the Finance Bill.

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## 18.8 KEY WORDS

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**Finance Bill :** The Finance Bill is the Bill embodying the Government's Financial (Taxation) proposals for the ensuing financial year which has to be passed by Parliament every year. It has a broader coverage in that it deals with other matters well.

expenditure. A Money Bill is a Bill certified to be such by the Speaker of the Lok Sabha.

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## 18.10 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

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### Check Your Progress 1

- 1) Your chapter should include the following points:
  - Financial administration of a country is executed through (a) the legislature (b) the Executive (c) the Finance Department (d) the Audit and (e) the Parliamentary Committee.
  - Legislature is the only competent organ of government in democracies which authorises the government to collect taxes and also to spend them in a particular manner.
  - The Legislative control is exercised through the operations of the Committees of Parliament.
  - The Comptroller and Auditor General of India—a statutory authority under the Constitution acts as a watch dog of the Parliament and conducts audit to see that the expenditure incurred by the Executive is for the proposes voted by the Parliament and is within the sanctioned grants.
  - The executive acting through ministers cannot raise money by taxation, borrowing or otherwise without the authority of Parliament and proposals for expenditure requiring additional funds must emanates from the cabinet.
  - The second principle that vests in the Lok Sabha the exclusive control of the money bills, which must originate in the Lok Sabha which has the sole power to grant money by way of taxes or loans and to authorise expenditure. The Rajya Sabha may reject a grant but not add to it.
  - The demand for grants must 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.
  - The proposal for a new tax or for an increase in the rate of an existing tax must come from the Government.

- 2) Your answer should include the following points:

- Question Hour

- Votes
- Budget discussions
- President Speech
- Legislature Committees – Public Accounts Committee, Estimates Committee, Committee on Subordinate legislation and the Committee on Assurances.

### Check Your Progress 2

1) Your answer should include the following points:

- Historically the concept of budget began to develop in the late middle ages when the revenue was supposed to be collected from the King's domain.
- After 1688 resolution the principle of 'No revenue without representation' got established
- The system of legislature 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 during the reign of King John was towards the control of receipts and revenues rather than 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.
- 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 significant historical developments in the arena of Legislative Control.

2) Your answer should include the following points:

- 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 by the House of Parliament.
- Article 109 (i) provides that a Money Bill shall not be introduced in the Council of States.
- Article 112 (i) provides that the President shall in respect of every financial year cause to be laid before both the Houses of the Parliament a statement of the estimated receipts and expenditure of the Government of India for that year.
- As per Article 113 (i), so much of the estimates as relates to the expenditure charged upon the Consolidated Fund of India shall not be submitted to the Vote of the Parliament.
- And also Article 114 (i), 116 (i), 117 (i) provides legislature procedures in financial matter.

### Check Your Progress 3

1) Your answer should include the following points:

- The function of the legislature does not end with the Voting of grants for Public expenditure. It 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, for this purpose, there is an independent audit of all the departmental accounts by the Comptroller and Auditor General of India followed by an examination of his report by a Parliamentary Committee.
- Public Accounts Committee scrutinises the appropriation accounts of the Government of India and the report of the Comptroller and Auditor General thereon.
- Estimates Committee is to report what economies, improvements in organisational efficiency or administrative reform, consistent with the policy underlying the estimates may be effected.
- The Committee on Public Undertakings 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 alongwith its own comments.

2) Your answer should include the following points:

## **Financial Control**

Union and the States and ascertains whether moneys shown in the accounts as having been disbursed were legally available 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, 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.

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# **UNIT 19    SYSTEM OF FINANCIAL COMMITTEES**

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## **Structure**

- 19.0    Objectives
- 19.1    Introduction
- 19.2    Need for Committees
- 19.3    Public Accounts Committee
- 19.4    Estimates Committee
- 19.5    Committee on Public Undertakings
- 19.6    Functioning of Committees—An Appraisal
- 19.7    Let Us Sum up
- 19.8    Key Words
- 19.9    References
- 19.10   Answers to Check Your Progress Exercises

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## **19.0    OBJECTIVES**

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After reading the unit, you should be able to:

- explain the concept of Financial committees
- describe and discuss the composition and functions of Public Accounts Committee, Estimates Committees and the Committee on Public Undertakings; and
- debate the various dimensions and issues involved in financial control

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## **19.1    INTRODUCTION**

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The term financial administration is used in a broad sense to include all the processes involved in collecting, budgeting, appropriating and expending public money, auditing income and expenditures, auditing receipts and disbursements; accounting for assets and liabilities and accounting for the financial transactions of the government and reporting upon income and expenditures, reporting upon receipts and disbursements, and the conditions of funds and appropriations.

Government like any other organisation, can achieve little without finance. Therefore, the efficiency of financial administration is an important aspect of Government's effectiveness. A government which has worked out a satisfactory system of financial administration has gone a long way towards putting the administration of its affairs upon an efficient basis.

The financial functions in Government are performed by the following agencies:

- 1) The Legislature
- 2) The Executive
- 3) The Treasury or the Finance Department
- 4) The Audit Department

Legislature has to determine by law the sources of government revenue. Executive has to provide the machinery and lay down the procedure of the collection of the revenue. Proper records or accounts of these revenues are to be maintained so that the accounts may be audited by an independent officer, who should submit an audit report to the legislature.

In financial administration, legislature plays the key role. All other agencies of financial administration act on behalf of the legislature, and are responsible to the legislature for all their activities. Hence legislative control over the finances and financial administration of the country is direct and pervasive.

In order to exercise proper control, the Parliament and legislature setup certain committees. Three such committees set up in India, namely, Estimates Committee, Public Accounts Committee and the Committee on Public Undertakings, which exercise financial control on behalf of the legislature. The purpose of financial control is to secure honesty and economy in expenditure. These agencies have to see that the tax payers money is rightly and properly used.

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## 19.2 NEED FOR COMMITTEES

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Effective legislative control over the expenditure of the government requires the Parliament to satisfy itself that the appropriations have been utilised 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 making the parliamentary control over governmental expenditure comprehensive. The legislature as such has neither the energy nor the time to perform these functions. It, therefore, constituted three committees, composed of members belonging to it, to devote themselves to these functions. These three committees are:

- a) Public Accounts Committee
- b) Estimates Committee
- c) and the Committee on Public Undertakings.

State legislatures also have similar committees though all of them do not have separate committees on public undertakings.

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## 19.3 PUBLIC ACCOUNTS COMMITTEE

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Historically, the Webby 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, called 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 by 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 by single transferable vote. Almost 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 continuity. The Chairman of the Committee is nominated by 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

- a) the moneys shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged;
- b) the expenditure conforms to the authority which governs it; and
- c) every reappropriation has been made in accordance with provisions made in this behalf under the rules framed by the competent authority.

It shall also be the duty of the Public Accounts Committee:

- a) to examine, 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 particular corporation, trading concern, or project;
- b) to examine the statements of accounts showing the income and expenditure of Autonomous and Semi-autonomous bodies, the audit of which may be conducted by the Comptroller and Auditor General of India either under the direction of President or by 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 include 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 organise itself into sub-committees and working groups. When approved by the committee, the reports of the sub-committees 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 make the work of the committee more effective, the Comptroller and Auditor General now submits interim reports to it. The committee is thus able to reach the conclusions and finalise 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 by the Government. But sometimes these are sent back for reconsideration. Most of the issues are thus settled through mutual discussion and free and frank exchange of views.

The Public Accounts Committee probes into the transactions carried 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 who will scrutinize what has been done, is a great check on the slackness or negligence of the executive.” The examination, if it is properly carried out, thus, leads to general efficiency of the administration. The examination by the committee may also be useful as a guide for both future estimates and policies.

The control exercised by the Public Accounts Committee is quite significant. The controls relate to financial matters and are quasi-judicial in nature. As a watchdog it acts as a deterrent on excesses committed by the executive. It is hoped that the committee will emerge as an effective force in the control of Public expenditure.

### Check Your Progress 1

- Note :**
- Use the space given below for your answers.
  - Check your answers with those given at the end of the Unit.

- When did the idea of Public Accounts Committee originate in India? What was its rationale?

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- What are the basic functions of Public Accounts Committee?

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## 19.4 ESTIMATES COMMITTEE

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The Estimates Committee was first created in April, 1950 and its functions were enlarged in 1953. There had been a predecessor or Estimates Committee, called 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 by 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 by the Speaker. If, however, 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 by the Lok Sabha or the Speaker to:

- i) report what economies, improvements in organisation, efficiency and administrative reforms, consistent with the policy underlying the estimates, may be affected;
- ii) suggest alternative policies in order to bring out efficiency and economy in administration;
- iii) examine whether the money is well laid out within the limits of policy implied in the estimates; and
- iv) 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 by Parliament are carried out. The basic 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 continuity is maintained by 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 collected. 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 study groups are appointed to undertake as on the spot study 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:

- i) Improving the organisation and working of the department;
- ii) Securing economies, and
- iii) Providing guidance in the presentation of the estimates.

The Committee has always interpreted its terms of reference in a liberal way. It takes the view that economy, efficiency and organisation are interconnected. The Estimates Committee is thus performing a useful work. Majority of its recommendations are accepted by the Government, as is revealed from the reports on the implementation of recommendations submitted by 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 by having sub-committees. The ultimate success of the Committee, however, rests on the influence it exercises on the Government in its long-term thinking and planning.

### Check Your Progress 2

- Note :**
- i) Use the space given below for your answers.
  - ii) Check your answers with those given at the end of the Unit.

- 1) When and why was the Estimates Committee set up in India?

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- 2) Evaluate the functioning of Estimates Committee in India.

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## **19.5 COMMITTEE ON PUBLIC UNDERTAKINGS**

Till April 1964 the affairs of Public Enterprises in India used to be looked after by the two Committees: namely the Estimates Committee and Public Accounts Committee. But in view of huge investments and manifold increase 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 by means of single transferable vote.

### **Functions of COPU**

The Principal functions of COPU are:

- a) to examine 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;
- b) to examine the reports, if any, of the Comptroller and Auditor General of India on the Public Undertakings;
- c) to examine, in the context of autonomy and efficiency of the public undertakings, whether the affairs of the Public Undertakings are being managed in accordance with sound business principles and prudent commercial practice;
- d) to exercise such other functions vested in the Public Accounts Committee and the Estimates Committee in relation to the Public Undertakings as are not covered by clauses (a), (b) and (c) above and as may be allotted to the committee from time to time.

The COPU shall not examine:

- i) Matters of major Government policy as distinct from business or commercial functions of Public enterprises;
- ii) matters of day-to-day administration;
- iii) matters for consideration for which machinery is already established by any

### **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. During the third Lok Sabha it submitted 40 reports. During 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 buildings; management and administration; Materials Management, Financial Management, Public relation and publicity, Production Management, Personnel Policies and Labour Management relations; Role and achievement of Public Sector Undertakings and Foreign Collaborations. These horizontal reports are very useful as they contain valuable information about one particular aspects 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 study tours, and after receiving formal memorandum and other information from concerned parties, non-official and official witnesses are invited to give evidence at formal sittings of the committee held at Parliament House. All evidence given before the Committee is treated as confidential.

The committee provides a whole lot of real and useful information on Public Enterprises operations. The enterprises are studied in some detail covering important aspects of their working with a view to making an evaluation of their performance.

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## **19.6 FUNCTIONING OF COMMITTEES—AN APPRAISAL**

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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 reorganisation of various departments keeping in view direct reduction in expenditure. The PAC deliberations are based on a post-mortem examination of reports produced by the audit, sometimes relating to some distant past rather than with matters which could create 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 by the thoroughness with which the audit examination has been conducted, 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 emphasized by the fact, that by 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 consistent with the policies underlying the estimates presented to the Parliament. The ultimate success of the committee, however, rests on the influence it exercises on the government in its long-term thinking and planning. This, in turn, demands that the committee makes 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 substantially altered the character and purpose of the committee." The committee is arrogating to itself a role, which constitutionally is that of the house. The committee makes many recommendations on matters of administrative reorganisation, reconstitution of departments and redistribution of functions. This has hardly any practical utility and many of its

recommendations are rejected by the government.

A thorough examination of working of the public enterprises by the COPU is the best available device of control over these enterprises by the Parliament. The COPU keeps the Parliament duly informed about their performance and how monies voted by it are, in fact, appropriated. Through the COPU the administration comes in direct contact with the Parliament. The COPU has done some useful work. In its tone, temper and manner of working, it is not different from the Estimates Committee and the Public Accounts Committee. But the advantage lies in the fact that it has been able to give sufficient time to the study of Public Undertakings because it is concerned exclusively with them. In the course of examination of causes and investigation of problems 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.

### Check Your Progress 3

Note : i) Use the space given below for your answers.

ii) Check your answers with those given at the end of the Unit.

- 1) Examine the functions of Committee on Public Undertakings.

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- 2) What are the weaknesses of parliamentary financial control in India?

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## 19.7 LET US SUM UP

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Legislature has to determine the sources of government revenue. Executive has to provide the machinery and lay down the procedure for the collection of the revenue. Proper accounts of these revenues are to be maintained so that the accounts may be audited by an independent officer, who should submit this audit report to the legislature.

Effective Parliamentary control over the governmental expenditure requires that the Parliament should satisfy itself that (1) the appropriations have been utilised economically for the approved purposes within the framework of the grants and (2) it should 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 important in making the legislative control over expenditure complete. Parliament performs these functions through three committees composed its members viz. Public Accounts Committee, Estimates Committee and the Committee on Public Undertakings.

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## 19.8 KEY WORDS

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**Public Accounts Committee :** Parliament exercises its control over expenditure, first by the provision of audit of Public Accounts by an independent and statutory

authority, the Comptroller and Auditor General of India and thereafter and examination of his report by PAC.

**Estimates Committee :** It examines in detail the estimates after they have been voted by Parliament with a view to securing possible economies in the execution of plans and programmes consistent with the policy implied in those estimates, and to make suggestions and recommendations which may, to the extent acceptable, be incorporated in the estimates for the subsequent years.

**Committee on Public Undertakings:** COPU has been set up specially for an indepth examination of the working of the Public Enterprises.

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## 19.10 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

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### Check Your Progress 1

- 1) Your answer should include the following points:
  - The Webly Commission of 1896 indicated the need for an account committee to highlight financial irregularities.
  - The Montague Chelmsford reforms suggested the creation of such Committee out of the provincial legislatures.
  - In India, the Public Accounts Committee was first created at the Centre in 1923.
  - Parliamentary control over finances of the government is assured through a special Committee of Parliament, called Public Accounts Committee.
  - A Committee of Parliament is preferred because the Parliament does not have the time to undertake a detailed examination of the report.
  - The Scrutiny being technical, can best be done by a Committee.
  - The non-party character of the examination is possible only in a Committee

- 2) Your answer should include the following points:  
 The functions of the Committee is to satisfy itself that
- money shown in the accounts as having been disbursed were legally available for and applicable to the service or purpose to which they have been applied or charged.
  - expenditure conforms to the authority which governs it.
  - every reappropriation has been made in accordance with provisions framed by the competent authority.
- It shall also be the duty of the Committee.
- to examine, in the light of the report of the Comptroller and Auditor General.
  - to examine the statements of accounts showing the income and expenditure of autonomous and Semi autonomous bodies.

### Check Your Progress 2

- 1) Your answer should include the following points:
- The Estimates Committee was first created in April, 1950.
  - Its functions were enlarged in 1953.
  - There had been a predecessor of Estimates Committee, called the Standing Finance Committee, which was first constituted in 1921.
  - It was attached to the Finance Department on the will of the executive; it had no statutory status.
  - Its functions were not clearly defined.
- 2) Your answer should include the following points:  
 It examines the estimates as it may deem fit or specially referred to it by the Lok Sabha or the Speaker to:
- Report what economies, improvements in organisation efficiency and administrative reforms, consistent with the policy underlying the estimates, may be affected.
  - Suggest alternative policies in order to bring out efficiency and economy in administration.
  - Examine whether the money is well laid out within the limits of policy implied in the estimates.
  - 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.
  - The basic function of the Committee is to ensure efficiency and economy in administration.
  - The Estimates Committee is performing a useful function in improving the efficiency of administration in India.

### Check Your Progress 3

- 1) Your answer should include the following points:
- to examine the reports and accounts of Public Undertakings.
  - to examine the reports, if any, of the Comptroller and Auditor General of India on the Public Undertakings.
  - to examine, in the context of autonomy and efficiency of the Public Undertakings, whether the affairs of the Public Undertakings are being managed in accordance with sound business principles and prudent commercial practices.
  - to exercise such other functions vested in the Public Accounts Committee and the Estimates Committee in relation to the Public undertakings as are not covered by clauses (a), (b) and (c) above and as may be allotted to the Committee from time to time.
- 2) Your answer should include the following points:
- The legislative financial control has become more nominal than real.



- The Estimates Committee deals more with economy and efficiency through administrative reforms and reorganisation of various departments, keeping in view direct reduction in expenditure.
- The PAC deliberations are based on a post-mortem examination of reports produced by the audit, sometimes relating to some distant past rather than with matters which could create an impact on the present financial performance. So it is a check rather than an effective control.
- The PAC is not vested with any executive power, and its function is limited to a scrutiny of Public expenditure.

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## **UNIT 20 EXECUTIVE CONTROL**

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### **Structure**

- 20.0 Objectives
- 20.1 Introduction
- 20.2 Evolution of Executive Control Over Expenditure
- 20.3 Role of the Finance Ministry
- 20.4 Delegation of Financial Power
- 20.5 Let Us Sum Up
- 20.6 Key Words
- 20.7 References
- 20.8 Answers to Check Your Progress Exercises

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### **20.0 OBJECTIVES**

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After reading the unit, you should be able to:

- explain the evolution of Executive Control over expenditure and the developments in the area of financial administration
- discuss the organisation of Ministry of Finance
- critically analyse the role of the Ministry of Finance, and
- briefly sketch the progress made towards delegation of financial powers and analyse the various problems in financial delegation.

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### **20.1 INTRODUCTION**

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The effectiveness of financial administration, in a democratic country, largely depends on the ability of the system to set up a smooth hierarchy of controls consistent with the unity of organisation on the one hand and decentralisation of political power on the other. If the financial machinery is to work smoothly and give good results, the principles of responsibility, accountability and control must find expression throughout the entire chain of operations. Maximum economy consistent with efficiency can be ensured only when waste, fraud, misappropriation, inadequate allocation for essential purposes, inefficient exercise of power, etc., are minimised through improved programming, supervision and control.

In order to ensure proper financial control, both the legislature and the executive have to play an important role. Legislature has to determine by law the sources of government revenue; whereas Executive has to provide the machinery and lay down the procedure for the collection of revenue. Executive control is one of the most important instruments of financial administration. Control in matters of policy concerning finance vests in the government as a whole. Government decides the policy of expenditure. Questions like pay, pension and provident fund to the officials are all determined by the government. The executive performs the policy-making function concerning finance, and then it is subject to the approval of the legislature. The Finance Department is always responsible for the entire financial administration of the country. The department performs a variety of functions with regard to finances of the country.

With the emergence of new tasks after Independence and the launching of Five-Year Plans, the implementation of the various programmes of economic and social development placed larger responsibilities on the administrative authorities and executing agencies. In order to achieve their goals realistically efficiently and economically the operating agencies need adequate facilities. Their prime requirement is control of their financial resources. This is only possible through delegation of financial powers.

## 20.2 EVOLUTION OF EXECUTIVE CONTROL OVER EXPENDITURE

Certain fundamental changes have been made in the environment of financial administration in India since Independence. An important 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 basic features of the federal structure introduced in 1935 continued. Attempts were made to capture the spirit of legislature financial control along with the institutional ingredients imbued with this democratic spirit.

Before Independence, Government of India Act of 1919 which embodied the recommendations of Montford Reforms was an important milestone on the road to decentralisation. 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 continued to be too slow, too specific and too 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. Thus the high degree of centralisation which characterised 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 aspect 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 various levels 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:

- i) Approval of programmes or policies in principle,
- ii) Acceptance of provision in the budget estimates, and
- iii) 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 generally 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 must 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 collected 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 generally interested, except in the most incidental or indirect way in the general financial problems 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 various services should scrutinise estimates in terms of their needs and spending capacity. This process 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 different 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 various 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 most important part in the execution of the Budget. Thus 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 by the Parliament to the executive. It is the duty of the executive to spend the money as voted by 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 by the executive beyond the appropriations provided by 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 by 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 requirements of a policy and the continuous comparison of actuals with budgeted results. This comparison aims at securing, through individual or collective action, the objectives of the policy or to provide a basis for its revision.

Such a control would, however, 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 between the actual and standard performance and reasons for these deviations, and taking suitable corrective action where examination of the deviations indicates that this is necessary.

The execution of the budget means:

- a) Proper collection of funds
- b) Proper custody of the collected funds
- c) Proper disbursement of funds.

## 20.3 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 by the Parliament, and for which resources have been duly appropriated. The finance department is always responsible for the entire financial administration of the country. The department performs a variety of functions with regard to finance of the country. It has control over expenditure of money. It controls and coordinates various 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;

- a) Administration of the finance of the Central Government and handling of financial matters affecting the country as a whole.
- b) Raising the necessary revenues for carrying on the administration and regulating the taxation and borrowing policies of the Government.
- c) Administration of problems relating to banking and currency and in consultation with the ministries concerned, arranging the proper utilisation of the country's foreign exchange resources.
- d) Controlling the entire expenditure of the Government in cooperation with the administrative ministries and departments concerned.

### Check Your Progress 1

Note: i) Use the space given below for your answers.  
ii) Check your answers with those given at the end of the unit.

- 1) Trace the evolution and development of executive control over expenditure in India.

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- 2) Discuss the duties of the Finance Ministry.

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### Organisation of the Ministry of Finance

The Finance Minister, assisted by a Minister of State in the department of Finance and the Deputy Minister of Finance, manages this most important 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, makes periodic assessment of foreign exchange needs and resources and takes steps to mobilise and allocate resources, 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:

- a) Budget
- b) Planning
- c) Internal Finance
- d) External Finance
- e) Economic and
- f) 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 connected with currency and coinage, Reserve Bank of India, Price control etc. The Planning division is concerned with the work connected with the preparation of the capital Budget and the allocation of ceilings of capital expenditure of the various 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 examine trends in the economy and to carry out studies and research with a view to advising the Ministry on questions of economic developments 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:

- a) Establishment Division including Implementation Cell and Staff Inspection Unit
- b) Defence Finance Division
- c) Cost Accounts Wing
- d) Plan Finance Division and
- e) 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 by the Finance Department for every item of expenditure even after the general policy has been accepted as a result of sanction by 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 centralisation of such powers is that there is no delegation of financial authority even to the high ranking and responsible officers of the various administrative ministries.

The scrutiny of expenditure by Ministry of Finance after Budget has been approved by the Parliament is due to the fact that often Administrative Ministries submit their schemes to the Finance Ministry during the last moments of the preparation of the estimates. There is generally inadequate prebudget scrutiny for want of

details in the case of many schemes. Since often schemes are included 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. Therefore, 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 by 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 between 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 between 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.

- 1) Before a scheme is embarked upon, it should be properly planned and it should also be ascertained, whether the money required for it is available or can be made available 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.
- 2) After the scheme is approved from the financial point of view by 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.

Thus, 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 by the Ministry of Finance, administrative ministries should be given more powers to incur expenditure on various 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 by the ministry in the ensuing financial year.

### Check Your Progress 2

- Note :
- i) Use the space given below for your answers.
  - ii) Check Your answers with those given at the end of the unit.

- 1) Outline the organisation and functions of Ministry of Finance.

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- 2) Critically analyse the role of the Ministry of Finance.

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## 20.4 DELEGATION OF FINANCIAL POWER

respect of creation of posts and contingent expenditure. 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 reorganisation 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 by 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.

However, the Ministry of Finance continues to be responsible for making a reasonable and fair distribution of the total sum determined by its ways and means position amongst the various programmes and activities of the government within the framework of the plan.

The Government has recognised the need for rationalising the procedures for expenditure sanctions and delegation of powers to the administrative ministries in their various 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 redelegate, in their turn, administrative and financial powers to heads of departments and to other subordinate authorities with due regard to their respective levels of responsibility. It is well recognised 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 various official levels. The need for delegation would vary in the case of different organisations depending on their respective programme requirements 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 by 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 levels vested with adequate powers. The need for speedy and efficient despatch of the public business makes it imperative that the functionaries at different levels should make 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 redelegation 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 by them. The Committee suggested that one of the ways to ensure that delegated powers are actually exercised is to create 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 recognised and appreciated while bonafide omissions and commissions are not held against them.

The A.R.C. study team on Financial Administration observed that—"A scheme of delegation of financial powers which does not become operative until the last detail is approved by the Finance Ministry is unsatisfactory. Once the preliminary feasibility report has been prepared and accepted by the government, the administrative ministry should be permitted to sanction expenditure on essential preliminary items, subject to a certain 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 important. It is, therefore, suggested that after the



preliminary feasibility report has been examined and approved by the government, the administrative ministries should have powers to incur expenditure within certain limits on the essential preparatory items pertaining the project."

Under the latest delegation schemes the administrative ministries have been given full powers of reappropriation 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 particular grant. In actual practice, the administrative ministries enjoy enough freedom in the matter of reappropriation of funds, even in these cases where reappropriation of funds could, under the rules, be done only with the prior sanction of the Ministry of Finance.

### Check Your Progress 3

Note : i) Use the space given below for your answers.  
ii) Check your answers with those given at the end of the unit.

- 1) What steps have been taken towards delegation of financial powers in India since Independence?

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- 2) Discuss the observation of Estates Committee, ARC on the need for delegation of financial powers.

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## 20.5 LET US SUM UP

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Finance being so vital to any organisation, especially Government, its administration is also an important study. A government which has worked out a satisfactory system of financial administration has gone a long way towards putting the administration of its affairs on an efficient basis. Thus, financial administration, involving the machinery and methods by which funds for the support of public services are raised, spent and accounted for, is at the very core of modern government. The financial functions are performed by legislature, the executive branch of the Government, the Finance Department and by the Audit Department.

Control in matters of policy concerning finance rests in the government as a whole. Finance Department is always responsible for the entire financial administration of the country. This department performs a variety of functions with regard to financial administration of a country.

From time to time the Government has recognised the need for rationalising the procedures for expenditure sanctions and has delegated enhanced powers to the administrative ministries in their various delegation schemes. The purpose is to improve the procedures for prebudget scrutiny and to delegate powers of post-budget expenditure sanctions to the administrative departments, within broad limits. There have been various issues in Executive Control over expenditure, control by Finance Ministry and the delegation of financial powers in the Government of India.

## 20.6 KEY WORDS

**Treasury or Finance Department :** First and foremost amongst the departments of administration stands the Department of Finance or Treasury. This department performs a variety of functions with regard to finances of the country.

**Executive :** One of the important agencies in financial administration is the Executive. The Executive performs the policy-making function concerning finance and then tries to get the approval of the legislature.

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## 20.8 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

### Check Your Progress 1

- 1) Your answer should include the following points:
  - certain fundamental changes have been made in the environment of financial administration in India since Independence.
  - formal acceptance of executive accountability to the legislature as the base of financial administration in India.
  - major steps towards more delegation of financial powers were made in 1958, 1962, 1968 and 1975.
  - high degree of centralisation which characterised the system of financial control in British India has been restructured over the 30 years of independence.
  - the procedures approvals and the tools of such a control have undergone much change.
- 2) Your answer should include the following points:
  - administration of the finances of the Central Government
  - handling of financial matters affecting the country as a whole
  - raising the necessary revenues for carrying on the administration
  - regulating the taxation and borrowing policies of the Government
  - administration of problems relating to banking and currency
  - arranging the proper, utilisation of the countries in foreign exchange resources
  - controlling the entire expenditure of the Government in cooperation with the administrative ministries and departments concerned

## Check Your Progress 2

## Executive Control

- 1) Your answer should include the following points:
  - The Finance Ministry at presents divided into:
    - Department of Economic Affairs
    - Department of Revenue and Banking
    - Department of Expenditure
  - Each department is under the charge of an independent Secretary, and for overall coordination of all the departments, there is a Finance Secretary
  - The department of Economic Affairs prepares the Central Government Budget, makes periodic assessment of foreign exchange needs and resources takes steps to mobilise and allocate resources, internal as well as external, in keeping with developmental and other needs.
  - Department of Revenue and Banking deal with, Income tax, Wealth tax, Expenditure tax, Customs, Central Excise. 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 is mainly concerned with the administration of expenditure control.
- 2) Your answer should include the following points:
  - The control of Finance department extends to the practice of requiring specific authority by the finance department for every item of expenditure
  - Executive control of the Finance department over finances of the country resulted in concentration of authority in only one Department of the Government.
  - The result of the centralisation of such powers is that there is no delegation of financial authority to the high ranking and responsible officers of the various administrative ministries.
  - There is generally inadequate pre-budget scrutiny for want of details in the case of many schemes.
  - Unless the expenditure sanctions are issued with the concurrence of the finance ministry, no part of expenditure can be incurred.
  - There should be more delegation of financial authority to the administrative ministries.
  - Administrative ministries should be given more powers to incur expenditure on various schemes and plans.

## Check Your Progress 3

- 1) Your answer should include the following points:
  - Greater financial power were delegated, in 1953: in respect of creation of posts and contingent expenditure.
  - These powers were further enhanced in 1954 and 1955.
  - A breakthrough, of key importance, came in 1958, when the Government of India sought to delegate financial power to the administrative ministries.
  - The Government has recognised the need for rationalising the procedures for expenditure sanctions and delegation of powers to the administrative ministries in their various delegation schemes.
  - The main objectives of these delegation schemes has been to improve the procedure for prebudget scrutiny
  - Delegating within broad limits powers of post budget expenditure sanctions to the administrative departments.
- 2) Your answer should include the following points:
  - The Estimates Committee in its Ninety-eight report in 1975-76 observed that there is a need for further redelegation of powers to the field agencies.
  - It endorsed the view that it is essential that they should have adequate powers commensurate with the responsibilities to be discharged by them.
  - It suggested that one of the ways to ensure that delegated powers are actually exercised is to create proper atmosphere for it.
  - The officers should be consciously encouraged to develop initiative and take decisions

## **Financial Control**

- It should also be ensured that methodical and conscious work and exercise of powers entrusted to officer is recognised and appreciated while bonafide omissions and commissions are not held against them.
- The A.R.C. observed that a scheme of delegation of financial powers which does not become operative until the last detail is approved by the finance ministry is unsatisfactory.
- It has been suggested that once the preliminary feasibility report has been prepared and accepted by the Government, the administrative ministry should be permitted to sanction expenditure on essential preliminary items.