

PUBLIC EXPENDITURE MANAGEMENT IN INDIA: STRUCTURE AND ASSESSMENT

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ABSTRACT

The national budget is the main instrument through which governments collect resources from the economy and allocate them. Since earlier times, Public finance concentrated on the study of public revenue and issues relating to taxation rather than the expenditure. Over the years, it has been found that major area of concern is to channelize public expenditure into those areas of the economy where its effects will be optimal in terms of growth, consumption and distribution. And more recently, the serious concern has been voiced regarding the effective utilisation of government funds and the paramount need to avoid wasteful expenditure. Insufficient revenues to meet all budget needs has resulted in continuous forced expenditure sequestration, lack of efficient controls over budgetary commitments, forcing fiscal adjustment from the federal to lower levels of government, and creating a large gray sector within government, which largely goes unrecorded and escapes regular budgetary controls. The overall strategy from a PEM perspective is twofold: a) to eliminate this gray noncash government sector by covering these transactions in the budget process; b) to improve the budget process by introducing more transparent, internationally accepted standards, both in budget preparation and execution, for all government operations.

Key words: Budget, Government, India, Public expenditure management, World Bank.

INTRODUCTION

How this allocation is done and how efficiently and effectively these collected resources are used, are some of the concerns of economies throughout the world. The periodical sharp increases lead to the acceptability of a bigger public sector, resulting from 'social upheavals'; viz., wars, acute inflation/recession (pump priming – contra cyclical fiscal policy); large scale natural disasters. Such upheavals cause a substantive spurt in public expenditure which **Peacock-Wiseman** stated in their hypothesis.

Another point of view is the **Wagner's' Law** which states that there is a positive link between size of government and economic growth. Despite the fact that it has already been proved in literature that the public expenditures have continually been increasing owing to various reasons, the problems related to essential, effective, productive and on time-using of the increasing public expenditures have gradually been enlarged.

According to **Pigou**, "Expenditure should be so distributed between battleships and poor relief in such wise that the last shilling devoted to each of them yields the same real return." The

same principle has been restated by **Dalton**, "Public expenditure should be carried just so far that the marginal social advantages of expenditure in all directions are equal and just balance the marginal social disadvantages of all methods of raising additional public income".

Though Dalton's principle of maximum social advantage is quite attractive in theory, there are practical problems in making it operational. Firstly, it is not easy to quantitatively measure the benefits flowing from diverse items of public expenditure for instance, expenditure incurred on defense and social security. Secondly, this theory cannot be subjected to a test. Evaluation of activities of the government is difficult due to the vast array of services and goals of the government and absence of an acceptable measure. To correct the inefficiencies of our fiscal framework (fiscal deficit), it is important that the management of public expenditure takes place.

On the other hand, macroeconomic stability requires, among other things fiscal discipline i.e. expenditure control; growth and equity requires, among other things, optimal allocation and efficient use of resources including allocation of public money conducive to growth. The public, international institutions and agencies are also demanding more efficiency and greater transparency. Issues like the global financial crisis; evolving economies; outdated policies, approaches and practices; and complex supporting systems are compelling governments to change the way public expenditures are managed.

The increasing significance of budgets in economy has obliged utilizing new techniques in managing it. Public expenditure management (PEM) is a basic means of government policy distributing and utilizing sources productively, effectively and sensitively. While expenditure policy is trying to find an answer for the question "what" is to be done, expenditure management tries to find an answer for the question "how" it is to be done.

While good governance requires adopting a policy framework that is responsive to the needs of the people, its effective and efficient management is equally important which results in appropriate investments in human resources, physical infrastructure and social protection. PEM therefore has to be a central and indispensable instrument of State policy and effective governance. This paper has made an assessment of PEM structure prevalent in India, its drawbacks, challenges and road ahead for such management. Qualitative approach has been employed in this study.

HISTORY OF PUBLIC EXPENDITURE MANAGEMENT

PEM approach was put into practice in the early 1980s by the World Bank. The 1983 World Development Report was entitled Management in Development, and this report led to the establishment of a unit in the Bank focusing on core issues of Public Sector Management (PSM). PSM has developed basic experiences and literature of public expenditure approach. This experience was summarized in the 1987 *World Development Report* by the management. The stress of institutional arrangements in the development of both private and public sector mentioned by North's (1991) has led the Bank's attention to concentrate on this direction. The World Bank has supported (World Bank Annual Report, 2000) many countries both technically and financially in terms of their harmony with medium-term approaches in public expenditures. Today, many countries have been able to develop (Anand & Krishnamurthy, 2001) their

institutional capacities for conducting budget allocations and budget plans better through PEM. Especially after the year 2001, it has been observed that expenditure allocations, provisions, financial management and evaluations which form the significant units of PEM approach have been followed by the countries at an increasing ratio. PEM approach has been taken into consideration not only by World Bank and IMF but also The Organization for Economic Co-operation and Development (OECD) and European Union has supported this approach. Examining the World Bank's studies, it is possible to see "medium-term expenditure system" which forms the most important step of public expenditure management and budget rules.

1 Budget and PEM

It has been observed that the objectives of PEM and budget processes are linked. The basic goals (principles) of PEM are accomplishing macro financial discipline, strategic priorities (productive source allocation) and functional application (technical productivity). These three objectives are complementary and interdependent. Without fiscal discipline, it is impossible to achieve effective prioritisation and implementation of policy priorities and programmes. Improving the internal management systems to achieve efficiency without a hard constraint is not credible. But mere fiscal discipline in the presence of arbitrary resource allocation and inefficient operations is inherently unsustainable. Beyond the three basic objectives, a sound system of PEM needs to take into account the wider values and requirements of society. Accountability, transparency, predictability and participation are important instruments for sound budget management, but also have an intrinsic value, and are generally seen as the four pillars of good governance.

The *Aggregate fiscal discipline* requires overall expenditure control, with expenditure estimates based on realistic revenue forecasts, and the capacity to set up fiscal targets and enforce them. The preparation of a macroeconomic and fiscal framework must be the starting point of budget formulation. To achieve aggregate fiscal discipline, the role of the ministry of finance is crucial.

Allocative efficiency operates at different levels within the government. The allocation of resources among "strategic areas" and/or line ministries entails appropriate arrangements at ministerial level, and between ministries, to formulate policies and decide on sectoral financial envelopes. The allocation of resources among programmes, projects, and activities within these strategic areas requires both appropriate arrangements within line ministries for sector policy formulation and adequate technical capacities within spending agencies to select the most cost-effective programmes, projects and activities.

Technical efficiency mainly concerns the operational level, and is dependent on arrangements to implement programmes within spending units on the basis of efficient and effective management systems.

Developing nations have been found suffering from some common (and questionable) assumptions about budgeting process. For example, there is a common pattern of budgeting that will fit all circumstances; the aim of budgeting is economic planning, improved budgeting depends on adequate resources, budget decisions can be separated from policy decisions,

whatever is best coordinated is best etc. Over and above such prevailing assumptions lie the rigidities in the budgetary allocations at the centre and state level. "Over the years the composition of Central Government expenditure has become highly rigid and prone to large, pre-committed increases. More than half of the annual budget outlays are transfer payments. Interest payments, Defense, Internal Security, Major Subsidies, Salaries, Allowances and Pensions and non-plan grants to States account for about 95% of non-plan expenditure and about 70% of total expenditure." (Finance Minister's Budget Speech while presenting Central Government Budget for 2009-2010). Table 1 brings out the items of expenditure accounting for about 92 per cent of the total expenditure where significant reallocation in a year or two may not be feasible without a medium term framework for the same.

Table 1: 2009-2010 Budget

	<i>Rs. Billion</i>	<i>Percent of Total</i>
Total Expenditure	3385	100.00
Interest Payments	1013	29.93
Defense	586	17.31
Subsidies	228	6.74
Pension	158	4.67
Police	67	1.98
(a) Sub-Total	2052	60.63
Transfers to States (Loans + Grants)	544	16.07
Support for Central Plan	513	15.15
(b) Sub-Total (Plan)	1057	31.32
(c) Sub Total (a) + (b)	3109	91.95

Source: Economic survey 2010

At the state level, the main fiscal problem is structural and, solutions attempted are incremental and consequently their major preoccupation is how to pay each day's bills. The state finance secretaries argue that whenever fiscal adjustment is attempted, there is a cut, in non-committed expenditure but not in non-essential one. A predominant part of the budget is committed expenditure, especially interest, pensions, and salaries, which has no flexibility. As a consequence, there is often an atrophy of delivery of services in as much as there may be hospitals manned by doctors and nurses but no medicines, electricity or water supply. Grants to several institutions performing vital services are often postponed or reduced on account of fiscal adjustment. In a conference arranged by the RBI for discussing the fiscal adjustment problems, there was virtual unanimity among the State Finance Secretaries that the structural problems underlying fiscal situation in the States cannot be solved unless the issue of high committed

expenditures is resolved. There was also a consensus that the fiscal problem is not State specific but an all-India phenomenon, often a result of policies of the Central Government such as in pay hikes and, solutions would warrant initiatives by and setting an example by the Union Government."

STRUCTURE AND ISSUES WITH PEM

For the purpose of assessing the PEM in India, the method adopted here is to first view the system as it exists today, find the strengths and weaknesses of the system and finally to identify the tasks ahead for each of the stages in the PEM cycle.

Let us first look at the basic structure of PEM through its broad objectives.

1. Effective Government

- Provision of services to the public within specified time and cost schedules.
- Achievement of allocative and technical efficiency.
- Ensuring that budgetary intent and outcome are congruent.
- Matching outlays with resources.
- Provision of management flexibility to the implementation agencies.

2. Responsive Government

- Achievement of macroeconomic stability.
- Responsiveness to changing economic situations.
- Responsiveness to the changing needs of the client/consumer.
- Provision of a choice to the client/consumer.
- Promotion of a utilization culture in lieu of a spending culture.

3. Accountable Government

- Accountability for results.
- Provision of accurate information on the status of government finances.
- Decision-making process to be transparent.

Even though PEM is an instrument of state policy and is to be used to achieve specified objectives of the policy, it has over the period of use, become multidimensional. Following are the dimensions through which the above mentioned objectives work:

(a) Economic and Financial

- Macroeconomic stability
- Effective budgeting
- Financial discipline
- Efficiency gains
- Program and project management
- Financial disclosure

(b) Public interest requirements

- Transparency
- Accountability

- Client orientation
- (c) *Political aspects*
- Political acceptability
 - Citizen participation.

The existence of public sector is paralysed with some weaknesses that undermine the public sector performance. The same weaknesses surface in the budget making process too. Aggregate fiscal discipline and the efficient allocation of resources are often impeded by the so-called "tragedy of the commons". There are many claimants to the budget, e.g. interest groups, legislators, line ministries. Each has preferences over the manner in which the budget should be allocated. The sum of these individual preferences puts pressure on increased expenditures.

The allocation of funds results from a series of forces that converge at different points of the decision-making process, with an arbitrator who rules according to an imperfect perception of present and future political realities. The ministries, the headquarters of the principal agencies, and many other decision-making positions are occupied by politicians who, theoretically, have developed a certain intuition about what people want." Budgetary outcomes are profoundly influenced by institutions, which comprise both formal and informal rules.

Transparency and accountability mechanisms are needed to impose implicit costs and, when relevant, explicit sanctions on politicians and bureaucrats for violating budgetary rules. Accountability is essential but does not become operational until one defines accountability "of whom", "for what", and "to whom". Accountability requires clarity in the definition of responsibilities. Being held responsible should lead to consequences that can include rewards or sanctions, as in the case of misuses of public funds. Accountability is required for a variety of areas from policy commitments made by politicians to operational activities.

Lack of predictability of financial resources undermines strategic prioritisation and makes it hard for public officials to plan for the provision of services (and is an excellent alibi for poor performance). However, assuring predictability does not mean making unconsidered promises, which would weaken fiscal discipline. Predictability is a relative notion, the challenging task being to deal with uncertainty in the most suitable manner, taking into account a country's economic and fiscal context.

PEM IN INDIA: AN ASSESSMENT BY JBIC

An attempt has been made by Japan Bank of International Cooperation (JBIC) to review, assess and find out the areas for reform in PEM in India. Both, the structural aspect (static) and the working aspect (dynamic) are analyzed for all the major elements in each of the stages of PEM cycle. Fiscal policy being an important component of the macroeconomic policy, the various stages of PEM cycle essentially starts from the stage of policy formulation for the budget.

1 PEM in India: Policy Weaknesses

- Very little feedback available with Budget makers.
- Rigidities do not permit sharp changes in policy particularly for inter-sectoral allocation.

- Very little scope of accommodating contingent requirements.
- Medium term policies for non-Plan budget items not specified.
- Annual budget allocations are often not corresponding to the five year allocation made in the five year plan.

2 PEM in India: Plan/Program/Activity Weaknesses

- Large part of the non-plan expenditure escapes activity-wise scrutiny.
- Absolute lack of cost (value for money) consciousness.
- No medium term perspective for the continuing activities and allocations for the same
- Lack of information on macro policy thrust at the level where budget estimates are prepared.
- Most spending authorities do not undertake any meaningful exercise to review the need for continuing the activity.
- Lack of feedback, performance results, information etc.

3 PEM in India: Monitoring of implementation Weaknesses

- Monitoring of physical progress is confined to major Plan programmes only.
- Activities out of the non-plan expenditure are not monitored except for information on expenditure incurred.
- Information system on physical progress remains weak particularly for socio-economic Programs.
- No mechanism of mid-course correction of Plan programs possible, for lack of timely reports of monitoring.
- Physical targets are often unrealistic in comparison to the financial allocations made by the Planning Commission.

4 PEM in India: Expenditure control Weaknesses

- The internal audit and control system remains weak as it is confined mainly to collection of information.
- Basically it is only an accounts oriented system. There is no audit or control over the objectives, tasks, outcomes or performance.
- The dimensions and complexities of the tasks of audit, very often, are responsible for restricting the scope of internal audit to routine checking of accounts.

5 PEM in India: Evaluation Weaknesses

- There is no regular mechanism for evaluating all the programs / schemes in a time bound manner.
- The focus of the evaluation studies has been only on finding the constraints in implementation and general impact.
- Most evaluation reports lack focus on 3Es (Economy, Efficiency and Effectiveness) aspects of the expenditure.

- Lack of professionalism and expertise of the evaluators.

Even the **Planning Commission, Government of India** illustrates the weaknesses of the PEM system as identified for different stages:

- Policies and budgetary provisions, despite the rhetoric, have not been integrated so far. The Indian planner, unfortunately, has still to understand the difference between planning and budgeting.
- The policy approach to agriculture, particularly in the 1990s, has been more to secure increased production through subsidies in inputs such as power, water and fertilizer, rather than through building new capital assets in irrigation and power.
- There are too many schemes to be monitored.
- There is unwillingness to accept poor performance
- Capacity to do monitoring is limited, and often does not exist. States even knowing that a scheme is not doing well become indifferent to its implementation.

6 PEM in India: An Assessment in World Bank Framework

General Observations

The World Bank annual report (2000) on India contains some general observations on governance and budgetary process in India along with evaluation and specific suggestions. A few important general observations are:

- India fares about average among developing countries, on Governance though it ranks well below industrial countries.
- India's 'outcomes' tend to be worse than the evaluations of its governance process, particularly in public service delivery, which suggests implementation problems.
- India's ranking on its budgetary processes and efficiency, and equity of revenues and expenditures in international comparisons is fairly high.

However, in terms of the more general category, of management of public finances, India-ranks much lower. An appraisal that is borne out by India's high fiscal deficit, where India ranks among the worst 10% of countries in the world

Tasks Ahead:

- (a) Strengthen policy formulation system.
- (b) Develop cost consciousness for each major activity/program.
- (c) Associate stakeholders, participants and beneficiaries with monitoring process.
- (d) Develop appropriate management systems for expenditure control.
- (e) Lay greater emphasis on program audit, efficiency audit and performance audit.
- (f) Focus 3Es (Economy, Efficiency and Effectiveness) in evaluation studies.
- (g) Ensure timely feedback for evaluation results to policy makers.

A positive development is that the Planning Commission has taken a serious view of the JBIC and WB reports and have not only started incorporating these reports in the Plan documents but also have initiated corrective measures.

MEDIUM-TERM EXPENDITURE FRAMEWORK (MTEF)

It is about linking policy, planning and budgeting at the government-wide level. It is a multi-year public expenditure planning exercise that is used to set out the future budget requirements for existing services, and to assess the resource implications of future policy changes and any new programmes. An MTEF is a whole-of-government strategic policy and expenditure framework within which ministers and line ministries are provided with greater responsibility for resource allocation decisions and resource use. The MTEF consists of a top-down resource envelope, a bottom-up estimation of the current and medium-term costs of existing policy and, ultimately, the matching of these costs with available resources. The approach to building an MTEF will depend on the conditions in the particular country. The more unstable fiscal policy is, the more out of balance are available resources and policy, program and project demands. The less integrated policy making, planning, and budgeting are, the more budget making is focused on funding. The more unsustainable particular categories of expenditure are (e.g., wages and salaries, pension, interest payments) the longer it will take to put in place a credible MTEF. A PEM oriented budgeting system focuses on promoting three budgetary outcomes — aggregate fiscal discipline, allocative efficiency, and operational efficiency (see *Governance Brief* issue 1-2001). While its principal focus is to promote allocative efficiency, an MTEF necessarily instills aggregate fiscal discipline and enhances operational efficiency.

The budgeting process in low income countries tends to result in the allocation of resources on a historical incremental basis. To fit within existing resource ceilings, programme managers submit bids which are cut at the last minute, often in an arbitrary manner. Links between the development and recurrent budgets tend to be weak or non-existent. Budget processes therefore lack credibility and provide little basis or incentive for sound planning even if the technical capacity exists to do so. Without this the scope for developing approaches based on sector or budgetary support is extremely limited. The development of an MTEF is one way to begin breaking this vicious cycle. The process is intended to allow policy makers to stand back from the day to day firefighting and reassess resource needs in the light of national priorities. The aim is to put in place a framework which offers some scope for significant resource shifts and offers a degree of continuity which is likely to survive changes in key personnel. So, an MTEF is one mechanism through which a PEM system can be operationalized.

1 Rationale of MTEF

1. Implemented successfully, an MTEF can **improve the efficiency** of public expenditure by locking countries into a process which, over time, channels resources from low value to high value uses and helps ensure that key services are adequately funded. In particular, the MTEF allows the future implications of policy decisions to be fully assessed and their affordability considered – something which the annual budget approach cannot do.
2. An MTEF can **improve predictability** of resource flows if estimates are based on more realistic assumptions about revenue. This can also improve efficiency, given that shortfalls are

often borne disproportionately by non-salary items which can seriously reduce operational efficiency.

3. An MTEF can **raise resource consciousness** and promote more **output or outcome focused** approaches by requiring line departments to be more explicit about what they propose to do, why they want to do it and what it will cost.

4. An MTEF improves **accountability** by encouraging governments to consider the medium/long term financial implications of their policy choices. Whereas ministries of health may be familiar with focusing their attention on developing new programmes, the MTEF approach encourages government to consider whether funds are best spent on strengthening existing programme. As such the emphasis is shifted away from the identification of new programmes towards a more balanced one which also considers issues such as expenditure control and resource allocation.

5. An MTEF can promote **inter-sectoral approaches**: the process emphasises the question: 'How can the health of the population be best improved?' rather than: 'Which health sector interventions are best at improving health?' In many ways the process of developing an MTEF and the questions it raises are as important as the actual output.

CONCLUSION

Transition countries recognise the importance of effectively managing government expenditure and are undertaking many important reforms in this area. Nevertheless, they are still burdened, to an extent that varies from country to country, by their inheritance from the previous regimes. In many transition countries, the tendency to impose decisions from the top, without adequate consultation and co-ordination, still creates inefficiencies in policy development and implementation. Need of the hour are some improvements in PEM, which are:

a) A greater focus on performance - the results achieved with expenditure.

This has the potential to engage all stakeholders in pursuit of budgetary and financial management reform.

b) Adequate links between policy making, planning and budgeting. This is essential to sustainable improvements in all dimensions of budgetary outcomes.

c) Well-functioning accounting and financial management systems. These are among the basics that underpin governmental capacity to allocate and use resources efficiently and effectively.

d) Attention to the links between budgeting and financial management systems and other service-wide systems and processes of government - for decision making, for organizing government, for personnel management. A well-performing public sector requires that all component parts work well and, where appropriate, together.

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