"The Budgetary System of National and Sub-national Governments in India"

Venudhar Routiya[1]

Introduction

The financial system of a State is influenced, to a great deal, by the economic policy of a country. The fiscal policy as a part of economic policy deals with taxation, public Expenditure, public borrowing and debt management. The budgetary policy and the budget documents are important parts of fiscal policy. That is why, the budgetary policy and the budget documents, to a significant extent, influence the functioning of a financial system of a country. Hence, in this Unit, we shall discuss the issues relating to budgetary policy and their bearing upon the Indian financial system.

India's Budget - India's public finance system follows the British pattern. The Indian constitution establishes the supremacy of the bicameral Parliament--specifically the Lok Sabha (House of the People)--in financial matters. No central government taxes are levied and no government expenditure from public funds disbursed without an act of Parliament, which also scrutinizes and audits all government accounts to ensure that expenditures are legally authorized and properly spent. Proposals for taxation or expenditures, however, may be initiated only within the Council of Ministers--specifically by the minister of finance. The minister of finance is required to submit to Parliament, usually on the last day of February, a financial statement detailing the estimated receipts and expenditures of the central government for the forthcoming fiscal year and a financial review of the current fiscal year.

The Lok Sabha has one month to review and modify the government's budget proposals. If by April 1, the beginning of the fiscal year, the parliamentary discussion of the budget has not been completed, the budget as proposed by the minister of finance goes into effect, subject to retroactive modifications after the parliamentary review. On completion of its budget discussions, the Lok Sabha passes the annual appropriations act, authorizing the executive to spend money, and the finance act, authorizing the executive to impose and collect taxes. Supplemental requests for funds are presented during the course of the fiscal year to cover emergencies, such as war or other catastrophes. The bills are forwarded to the Rajya Sabha (Council of States--the upper house of Parliament) for comment. The Lok Sabha, however, is not bound by the comments, and the Rajya Sabha cannot delay passage of money bills. When signed by the president, the bills become law. The Lok Sabha cannot increase the request for funds submitted by the executive, nor can it authorize new expenditures. Taxes passed by Parliament may be retroactive.

Evolution of Budgeting System in India

Kautilya's Arthashastra, which describes the administration during Mauryan period makes reference to an excellent budget system with very detailed, minute rules about the maintenance, preparation, submission and scrutiny of accounts.

[1] Assistant Professor, School of Studies in Law, Pt. Ravishankar Shukla University, Raipur (C.G.), India.

Every year, the Finance Minister made a note of the opening balance in the Treasury, of all current. expenditure, including capital projects in hand (Karaniya) as well as those which had been completed (Siddham). Along with this there was a detailed statement of receipts from all sources; and also a statement of the anticipated at the end of the year. Full and precise accounts were kept of all receipts and outgoings, on Revenue and Capital accounts;

Plans were also prepared and included in the budget of all proposed new and profitable expenditure for investment.

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

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

The main activity of the East India Company being territorial expansion, expenditure on costly wars mounted. Huge sums were remitted to England on account of interest payable on Indian debt, interest on investment on Railways, civil and military charges supposed to have been incurred in England on behalf of India, including the expenses on the maintenance of the Office of East India Company in India. That the Governors of the three presidencies hardly had any powers can be seen from the fact that no governor could create a permanent post carrying a princely salary of more than Rs. ten per month. Following the first war of Independence, in 1857, there was chaos in financial administration. With the takeover of the Indian administration by the Crown, the financial system came to be fashioned on the lines of the system prevailing in England. imperial objectives dictated a highly centralized system of financial and administrative control. As we have discussed in Unit 2, the first budget was formally introduced in India in 1860 by Sir James Wilson, the then Finance Member of the Governor-Generak-in-Council. There was at that time no elected legislature in India.

The budget was also not presented to the British Parliament. The budget, however, made the **Viceroy/Governor-General-in-Council** accountable to the Secretary-of- State-in-Council in London who, as a member of the British Cabinet, looked after Indian affairs. The Secretary of State became the fountainhead of all authority. He delegated powers to the Governor-General of India. The powers had to be exercised within the ambit of rules and regulations which had to be strictly followed. According to Thavaraj, the basic features of the financial system in India during the period 1858- 1935 were:

i) The Secretary-of-State-in-Council was the chief regulator of the financial system,
ii) Governor-General-in-Council exercised delegated financial authority;
iii) Finance Department was the custodian of Indian finance and
iv) Controller General had combined responsibility for Indian Audit and Accounts.

The Secretary of State controlled Indian finances through:

a) acceptance of the Indian budget;
b) Regulation and control of expenditure through voluminous rules, regulations and codes; and
c) Through numerous executive orders.

The budgetary system, more or less, retained these features in spite of the reforms introduced by Lord Mayo in 1870, Lord Lytton in 1877, Lord Rippon's Quinquennial Settlements of 1882 and Lord Curzon's Reforms, 1904. The scene, however, changed significantly following Montague-Chelmsford Reforms of 1919. From 1921 onwards, the Central Legislative Assembly, with a non-official majority, was for the first time given the right to discuss and pass the annual budget of the Government of India in respect of 'non-reserved' subjects, as also to pass the Finance Bill embodying taxation proposals. The Governor-General was, however, empowered to "certify" the financial proposals in the event of their rejection by the legislature. Before these reforms were introduced, the provincial governments had to seek the approval of the Central Government for every rupee spent. The Montague- Chelmsford Reforms for the first time introduced realistic provincial autonomy. Central and provincial heads of revenue were clearly demarcated. Consequently, the importance of the supervisory role of Finance Member over the provincial finance departments declined considerably and vanished altogether after 1935. The Secretary of State, however, did not suffer any diminution in his supreme authority after the 1919 dorms. Nothing of significance could happen without his knowledge. But he intervened only when the imperial interests were in jeopardy.

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

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

Principles of Budgeting

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

i) Principle of annularity. The budget should be on an annual basis; this leads to another rule "the rule of lapse". The operation of this rule leads to a rush of expenditure towards the end of the year. However it has the merit of enforcing parliamentary sanction-which is always for an amount for a specific period after which it must be obtained again. This implies that if the funds voted are not used by the end of the financial year, the unspent balance lapses.

ii) The government budgets are on cash basis.

iii) There should be one budget for all financial transactions of the government. In the absence of one common budget it would be difficult to assess the true financial position of the government. Railways and other public enterprises, however, have separate budgets. In the case of railways, total receipts and expenditure are incorporated in the Central Government Budget. The estimates of capital and loan disbursement and also the extra budgetary resources for financing the plans of public enterprises are also shown in the Central Budget.

iv) The budgeting should be gross and not net. Gross transactions, both in the case of receipts and expenditure of each department, should be shown. It is not permissible to deduct any receipt accruing to the department from the charges of collection or any other expenditure. This is intended to ensure that the parliamentary control over expenditure is meaningful. In the absence of this provision, the budget coming up before the Parliament would be reduced only to the net deficit, if any.

v) Budgeting should be close. It should not be guess work or guess estimates which result in wide fluctuations and can lead to improper allocation of funds. Supplementary grants.

vi) The form of estimates should correspond to the accounting heads since the estimates eventually get converted into actual accounts of receipts and expenditure.

Indian Fiscal Policy

In the process of economic development, fiscal policy as an important instrument of economic policy plays an important role in the development and planning system of a country. Through fiscal policy, the Government provides public services. At the same time, it is an instrument for reallocation of resources according to national priorities, redistribution, promotion of private savings and investments and the maintenance of stability. Fiscal policy is concerned with the aggregate impacts of various policy measures on the prescribed set of objectives. Therefore, it is in a broader framework, a measure to achieve the prescribed objectives in an economy. In other words, fiscal policy is a mean to achieve the chosen objectives like, economic growth, generation of employment opportunities, distributive justice, removal of poverty, price stability, etc. It is clear from the above discussion that fiscal policy has a multi-dimensional role.

Providing social justice to various segments is the major objective of this policy. In a developing country, like India, the fiscal policy has an added importance as it is assigned an important role to achieve full employment and economic stability, and thereby achieving meaningful growth rate. Fiscal policy, on the one hand, concentrates on the resource mobilization in the economy. The system of taxes diverts funds from the private sector to the government sector. On the other side, the system of public expenditure diverts funds from government sector back to the people as they are spent for productive and welfare purposes. Public borrowings are also used for various purposes. Public debt management includes functions like floating of government loans, payment of interest and redemption of debts. The fiscal policy is formulated to fulfill the following objectives:

i) Mobilization of resources so as to increase the rate of investment and capital formation. This, in turn, accelerates the rate of economic growth,
ii) Reduction of inequalities of income and wealth, or redistribution of income, in other words, an equitable distribution of income,
iii) Increase in employment opportunities, and
iv) Price stability.

The Basics of System Financial

In order to achieve these objective, the Government resorts the following instruments:

i) Taxation
ii) Public Expenditure
iii) Public Debt

These instruments affect the functioning of financial sector in the following manner:

i) Taxation

Taxation has a direct bearing on savings, investments and consumption. If the direct tax rates were high, there would be lesser savings and would also affect the Consumption pattern.

At the same time, if the tax rates are brought down, it would affect public investments. In such a contradictory situation, the Government has to take very precautionary step, as high corporate tax rate would affect the prices adversely. At one point of time, the corporate **tax** was quite high. However, with the process of liberalization it has gradually been reduced. The reduction in corporate tax creates multiple beneficial effects all round and also attracts foreign investments.

ii) Public Expenditure

Public expenditure, apart from influencing the economic growth process, has its real bearing on the activities of financial sector. In the event of more spending through public investments, various sectors of the economy flourish, which in turn raise the demand for private investments from financial system. For example, if Government develops good infrastructure in a particular zone, more industries would come up and will demand the financial assistance from banks and financial institutes.

iii) Public Debt

The public debt comprises of internal and external debt. Internal debt includes market loans, bank temporary loans by way of treasury bills issued to RBI and commercial banks. Public debt policy affects financial sector. When Government has more borrowings, it adopts various tools such as increased level to statutory liquidity ratio to be imposed on banks, issue of treasury bills etc. All these measures reduce the credit capacity of financial institutions and these are left with less credit availability for productive purposes. Thus, fiscal policy affects savings, investments, credit capacity, demand for credit in a financial system etc. that have direct bearing on operations of financial sector as a whole in the economy.

Budgetary System: A review

The document integrating the revenue and the expenditure of Government is called the **'Budget'.** A budget contains the actual estimates of revenue and expenditure of the Government of preceding year, revised estimates of the receipts and of the Government for the current year and the estimates for the next year. It has a role to ensure that the tax burden is reasonably imposed. On the other side, it ensures justice in allocation of expenditure among various sectors of the economy. The budgetary policy is essentially concerned with:

a) Raising of revenue
b) Incurring of expenditure by the Government

The budgetary policy has been modified from time to time and made more pragmatic not only to enhance the tax resources but also to ensure that maximum people are brought within the tax net. The tax **GDP** ratio in India was just 6% in 1950-51, which increased nearly to 14% in **1999-**2000.

The Budget statement has been instrumental for. Providing special incentives for private savings and also encouraging investments in specified areas like housing. The budget strategies are revised every year keeping in view the overall economic growth of the country, requirements of resources, and allocation of funds according to priorities. Fiscal deficit seen at 5.1 percent of GDP in 2010-11 and 4.6 percent of GDP in 2011-12.

The Indian financial system consists of variety of institutions, markets and instruments that are closely related with each other. It provides the principal means by which savings are turned into investments. Given its role in the allocation of resources, the efficient functioning of the financial system is of crucial importance in a developing economy, like India.

The financial institutions/financial intermediaries, as they are called, comprise commercial banks, insurance companies, mutual funds, non-banking financial companies, development financial institutions etc. The financial markets comprise of capital market and money market, whereas financial Instruments are demand deposits, short-term debt, intermediate term debt, long-term debt and equity, bonds etc.

Broadly the important functions of financial system can be described as under: -

i) It enables the pooling of funds for setting up large-scale enterprises.
ii) It provides a way for managing uncertainty and controlling risks.
iii) It provides a mechanism for spatial and temporal transfer of resources.
iv) It generates information that helps in coordinating decentralized decision-making.
v) It provides a payment system for exchange of goods **and** services.
vi) It helps in dealing with information gap by handling sensitive information discreetly.

Role of Budgetary Policy in the Growth of Financial Institutions

The primary role of a financial institution is to serve as an intermediary between lenders and borrowers. These institutions work under the overall supervision of the Reserve Bank of India. The funds pooled by the financial institutions are invested in diversified portfolios of financial assets. The transaction cost is lower. The financial institutions supply the ultimate lenders with liquid and less risky financial assets. Thus, financial institutions act as intermediaries between investors and savers. The process of financial intermediation results in:

a) Providing savers with different varieties of financial assets to invest their funds according to their preferences. It enables them to increase their savings.

b) Borrowers are also benefited as finance is provided through the institutions as it is not easily possible to obtain directly, from savers.

c) I t raises Lye productivity of aggregate investment, by improving its allocation.

This apart, financial intermediaries also perform the important function of facilitating the normal production process and the exchange of goods and services. The financial institutions, thus, play a vital role in the economic development of the economy. Broadly, these institutions are classified into following categories:

a) Development financial institutions
b) Insurance companies
c) Other Public sector financial institutions
d) Mutual Funds
e) Non-Banking Finance Companies

The objective of budgetary policy is to strengthen the financial base of these institutions and to provide them operational freedom.

A distinct feature of the Indian financial system is dominance of public sector institutions. Motivated by socio economic considerations, the system has been subject to high degree of regulations. Both entry of a new entity and its expansion have remained under the control of State. There has been a mandatory allocation of credit amongst different sectors including the government. Confessional interest rates have also been introduced.

In the recent past, the following budgetary policy measures have been initiated:

i) The financial institutions have been given more autonomy in their operations. They have also been permitted to expand their operations in the financial sector by opening new outfits.

ii) Prudential norms relating to capital adequacy, income recognition, classification of assets and provisioning have been made applicable to these institutions.

jii) Insurance sector has been opened to the private sector. This will not only provide healthy conditions but also better risk cover and returns to investors. Insurance Regulatory and Development Authority has been set up to monitor the insurance institutions.

iv) Budgetary allocation has been made to expand the capital base of NABARD, which in turn will accelerate the growth of agricultural sector and rural development.

v) Certain tax incentives have been extended for investment in mutual funds.

The banks mobilize surplus funds through various channels of savings. The flow of savings in the economy directly depends on budgetary policy measures. As already indicated that taxation policy, public expenditure and public debt policy affect consumption and savings, the extent of savings is much related to fiscal measures. Likewise, the expansion of credit also depends on investment policy being pursued by the Government to encourage private investments. If there are more fiscal incentives for industrial expansion, it will attract more demand for credit. Even Government's demand to meet current expenditure would limit the availability of loan able funds from the banking system. The commercial banks transfer funds from surplus units to deficit units at the minimum operating cost. Today, we have vast network of bank branches operating all over the country. The nationalization of commercial bank in 1969 was a turning point in the history of banking in India. There have been significant achievements and pitfalls during this period.

The Budgetary policy has initiated a series of measures to make the banks more responsive to economic growth. Some of the recent measures are as under:

i) The banks are required to be more vibrant and their capital base has been strengthened. To meet the capital adequacy norm of 8%, a budgetary support of over Rs. 20,000 crore is provided to weak banks.

ii) To make the bank credit cost effective, tax on loan interest has been withdrawn.

iii) In the budget document, through rigorous exercises, attempts have been made to bring down the deficit, which in fact has helped banks to control flow of credit to government on confessional rate of interest.

iv) To boost the export business, the government has set up Export Import Bank of India. The initial capital wp; contributed through budgetary resources.

v) Banks have been facing serious problem with regal& to recovery of their loans particularly the non-performing; assets. The government has set up Debt Recovery Tribunals to expedite the cases of banks and accelerate recovery process.

vi) The budgetary policy provided specific provisions and incentives for increasing the credit to high-tech agriculture projects.

vii) The banking sector has been provided greater antimony in their functions. The entry of private and foreign sector banks has been permitted to bring more competitiveness and efficiency in the working of banks.

viii) For greater credit expansion and wider acceptability of banks in rural areas, the Regional Rural Banks (RRBs) have been set up.

ix) The development of housing sector received prairie attention in the budgetary policy. National Housing Bank has been set up. Tax concessions have been provided the borrowers.

x) The budgetary policy has initiated several other policy measures for the benefit of specified sectors like poor people, agriculturist, educational loans, etc.

xi) The Statuary Liquidity Requirement (SLR) and the Crash Reserve Requirement (CRR) of banks have been reduced significantly to release more loan able funds to the banks.

xii) To reduce its stake in the ownership of nationalized banks, the Government has decided to reduce its equity to **33%** in case of such banks. Thus, the budgetary policy has provided greater flexibility in banking operations and has made them more stronger to play a vital role in the financial system. In the Indian financial system, there are two broad segments of the financial market:

i) money market, and
ii) capital market.

i) Money Market

The money market deals with short-term debt. The principal players in the money market are the commercial and other banks in addition to LIC, UTI, Mutual Funds, and non banking financial companies. These intermediaries lend funds on a short-term basis to create an active inter bank call loan market. The Discount and Finance House of India (DFHT) provides liquidity to money market instruments by creating a secondary market.

ii) Capital Market

The capital market deals with long-term debts and stock (equity and preference). Each of these markets has a primary and secondary segment. New financial assets are issued in the primary market while existing financial assets are traded in the secondary market. The growth of capital market is influenced, to a great extent, by various budgetary policy measures. For example, the taxation policy of corporate tax, dividend tax, capital gain tax, fiscal incentives for small savings etc. have direct impact and set the direction of growth of capital market. On the other hand, various fiscal incentives for industrial expansion would cause more demand from capital market by industrial sector. The instruments of capital market have long period for maturity. It is a source of raising capital by issuing securities. The primary capital market facilitates the formation of capital. The secondary market consists of stock exchanges recognized by the government. The National Stock Exchange and Over the Counter Exchange of India provide liquidity to the secularities. The Securities and Exchange Board of India (SEBI) oversees and monitors the functioning of securities market and operations of intermediaries like mutual funds and merchant banks. Besides, there is a market for government securities which deals with debt securities issued by central/ state governments, all India financial institutions and other autonomous institutions.

Budgetary Policy and the Financial Instruments

Financial instruments are generally defined as moizelary obligation of a borrower of funds (the issuer of the instrument) to the holder of the instruments. 1701- the issuer of the instrument, it is a liability or in other words, financial obligation, for the holder it is a financial asset.

Financial instruments may be issued by economic units (private as well as public). The major financial instruments in an economy are as under:

i) Demand Deposits

Demand deposits are the financial instrument. which are payable on demand to the owner by the holder. It may or may not carry interest. These are usually held by the banks by way of current and savings deposits and by post offices by way of savings accounts.

ii) Short-Term Debt

This is a promise to repay a specified sum along with agreed rate of interest within a short period of one year. Treasury bills, commercial papers, certificates of deposits and few other innovative instruments have been introduced in the system.

iii) Long-Term Debt

These are the debt instruments repayable over a period of 5 to 7 years in case of corporate sector and over 10 years in case of government bonds. They carry a specified coupon rate. Private and public sector debentures and bonds fall in this category. The debt instruments have been made more lucrative rith variety of options and reasonably better yield.

iv) Equity Stock

This is a popular means of raising resources as capital by the corporate sector. Being owners, the equity shareholders have residual interest in the income of the company as they receive dividend after the' claims of all creditors are met. The budgetary policy has aimed from time to time that various financial instruments depending on variety of needs are brought into the system. They perform both the functions of financial assets and financial liabilities. In this direction, the budgetary policy has a very important role because the nature of new financial instruments and their innovativeness depend on budgetary policy decisions. Such incentives are in the form of tax incentives to attract more savings, growth of investments to meet increased money supply and growth of capital market in tune with changes in policy measures for industrial growth.

The budgetary policy has made the financial instruments as discussed above, more acceptable. Some of the other financial contracts like forward futures, swaps, options and pension funds have been introduced in the system. The following are some of budgetary policy measures, which have increased the utility of above instruments in the financial system.

i) The ceiling coupon rate on bonds has been abolished.
ii) Some specified bonds such as infrastructure and power development have been given tax benefit.
iii) The volume of money market instruments has been increased.

Although, in ancient India, a fairly developed budgetary system was prevalent, it is only after the British Crown took over from the East India Company in **1860** that a modern budget was introduced. The Secretary of State in the Council was the chief regulator of the financial system in India and the Governor General in the Council exercised delegated financial authority. Finance Department was the custodian of Indian finances. As we have discussed in the unit many reforms were introduced, particularly in 1919 and later in 1935. The system of financial control which India inherited in 1947, turned out to be very rigid, rule-oriented and complex. Necessarily it was an adjunct of the fundamental imperial objectives rather than an instrument to solve national problems.

The budgetary process under the Constitution follows the procedure laid down in Articles 112 to 117. The budget shows receipts and payments under three parts in which government accounts are kept; these are Consolidated Fund, Contingency Fund and Public Account. The budget comprises Revenue Budget and Capital Budget. The budget estimates of expenditure which are to be voted by the Lok Sabha are submitted in the form of Demands for Grants.

Generally, one Demand for Grant is presented in respect of each ministry or department. The budgeted expenditure is also classified as plan and non-plan. Bulk of the expenditure represents standing charges or committed expenditure and is non-plan. **X** large part of the plan expenditure incurred by the Central Government is through /public sector enterprises.

These are the four stages in the budgetary cycle. viz; preparation, approval, execution of the budget and audit. Preparation of t**he** budget usually begins on the receipt of a circular from the Ministry of Finance during September/October. It contains reformation relating to the budget estimates of the current year, revised estimates, actual for the previous year and the proposed budget estimates for the next financial year.

The budget is presented to the Parliament on the last working day of February. **A** general discussion **is** followed by a detailed discussion on each demand for grant. The Parliament may reduce or reject but may not increase any budgetary provision which is subject to its vote. After the Parliament has voted the demand for grants, an Appropriation Act has to be passed by it to enable the government to withdraw money from the Consolidated Fund of India. The executive spends the money in accordance with the powers delegated to the operational levels. Finally, the expenditure is audited by the Statutory Audit to ensure that the public funds have been used as authorized and that rules and regulations have been observed.

References

Burkhead, Jesse, 1956. *Government Budgeting,* John Wiley & Sons : New York.

Premchand A, 1983. *Government Budgeting and Expenditure Control: 7'heory and Practice,* IMF : Washington DC.

Thavaraj, M.J.K., 1978. *Financial Administration of India,* Sultan Chand and Sons : Delhi.