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India - Overhaul of the Budget Process

The Indian Government has taken three important decisions regarding the budget process: (i) to merge the railway budget with the main budget; (ii) to advance the budget presentation by a month from end February to end January; and (iii) to remove the distinction between plan and non-plan expenditures. Although not transformative, these three changes are positive developments, and together with the expected roll out of the goods and services tax (GST) starting next fiscal year, imply a significant overhaul of the budget process. This paper evaluates these changes.

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Merger of the Railway Budget with the Main Budget

The intent behind the merger seems to be to free the railways - the largest state owned public enterprises in India - from populist pressures and stressed finances. A separate budget is a colonial legacy, going back 92 years, presumably started because of the importance of railways to the colonial economy, accounting as it did for nearly 80 percent of public revenues and public expenditures at that time. At the height of Britain's colonial power in India, exports to India accounted for over 20 percent of total British exports; in

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the reverse direction, Indian exports of cotton, tea and spices to Britain were an important component of the British economy. An extensive railway network connecting the ports to the vast hinterland of the country was critical to this British – India trade.

The practice of a separate railway budget continued after independence more for political economy rather than economic reasons. The railway ministry came increasingly to be seen as a populist perch for the minister to dole out largess by way of low passenger fares, new trains and fresh railway projects largely on vote bank considerations even if efficiency got compromised and safety concerns were pushed to the backburner.

The abolition of a separate railway budget, it is expected, will 'deglamourize' the railways portfolio and insulate the railways from political pressures. Away from the glare of an exclusive budget, decisions on fares, new trains and fresh projects will be based on need, cost and efficiency considerations.

There has been some commentary about how this merger of budgets will free the railways from paying a huge dividend to the government. This is somewhat of a narrow perspective; it makes little difference for the combined balance sheet of the national exchequer. After all, what the railways 'gain' will be a cost to the rest of the government. There has also been commentary that the merger of the budgets will erode the functional and financial autonomy of the railways. But, wasn't that the main point of the merger?

This budget merger will not amount to much unless it is followed up by two logical next steps. The first is to establish a regulator who will decide on passenger fares and freight rates, minimizing, if not ending, the extensive cross subsidization of passenger fares by freight rates, inherent in the current pricing structure. The second is for the finance minister to move towards a combined budget allocation for all modes of surface transport – sea, rail, roads – so that project selection is based on overall efficiency rather than wasteful silo considerations.

Advancing the Budget Presentation

The second reform – advancing the budget presentation by a month from late February to late January – is also informed by efficiency considerations.

Under the current calendar, the budget is presented to the parliament on the last working day of February and gets approved only by the end of May. Since the financial year starts from April 1, this schedule implies that budget allocations are not available to the ministries for nearly two months into the financial year. Since monsoon sets in in June, project implementation does not start until October, a full six months into the financial year. Advancing the budget presentation to end January will enable budget approval by March end so that project implementation can hit the ground running at the beginning of the financial year. The revised schedule will also enable firms and households to plan their spending, investment and savings with a full financial year perspective.

The only downside to the revised calendar is that budget estimates will have to be based on data and projections on total income, growth of output and the monsoon outlook based on January data which will have greater uncertainty than the data available in the February data.

Quite apart from this revision of the budget calendar, the government is considering a change on the financial year itself. Currently, the financial year runs from April 1 to March 31 – again a colonial legacy – which drew its rationale from the monsoon season spanning June – September. Given the importance of agriculture to the economy and the dependence of agriculture on the monsoon prospects, the April – March financial year enabled a better evaluation of the monsoon prospects and building them into the budget planning for the full year. That logic has lost its strength since the share of agriculture in GDP has since fallen to below 15 percent. The proposal under consideration now is to synchronize the financial year with the calendar year which, it is expected, will be consistent with the broad international practice.

Removing the Plan–Non-Plan Expenditure Distinction

The third reform now approved is to do away with the plan–non-plan expenditure classification in the budget and to stay with only revenue and capital expenditure classification.

Revenue expenditure (current expenditure in international terminology) is what the government spends on day to day running of departments and services, interest payments

and subsidies, while capital expenditure is funds spent on creating capital assets like infrastructure, machinery and projects.

The plan–non-plan expenditure distinction actually originated with a neat rationale. Plan expenditure referred to expenditure - both revenue and capital - on new projects while non-plan expenditure related to expenditure on existing projects and services. Over the years, this rationale got overtaken by politics. Plan expenditure came to be glorified as ‘desirable’ while non-plan expenditure came to be seen as unproductive or even wasteful. This was far from the reality as non-plan expenditure included important elements like maintenance of existing projects which most of the time yielded better value for money than spending on new projects. But increasing the spending on new projects, even if it was inefficient, came to be seen as an end in itself, and allowed politicians to win brownie points – a clear case of political virtue militating against economic virtue.

Given this state of affairs, doing away with the plan–non-plan distinction was a wise move although it was a case of throwing away the baby with the bathwater.

Rollout of GST

The central and state governments are working vigorously to roll out the GST from April 1, 2017. If and when the GST becomes a reality, there will not be much for the finance minister to unveil by way of taxation proposals in the budget since the indirect tax rates – the real surprise elements of the budget – will be set by the GST Council.

The budget will lose much of its aura and mystique. Just as well perhaps!

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