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# UNIT 7 GOVERNMENT BUDGETING: PRINCIPLES AND FUNCTIONS

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## 7.0 OBJECTIVES

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After studying this unit, you should be able to :

- state the meaning and components of budget
- explain the general characteristics of budgeting systems
- identify the important functions which budgets usually perform; and
- describe the classification system according to which budgeted expenditures are classified.

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## 7.1 INTRODUCTION

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A single item of public expenditure or that of public revenue cannot be judged in isolation. Whereas public expenditure is designed to promote welfare, the taxes impose costs on the tax payers. The welfare and costs, utility and disutility of government financial transactions, need to be balanced. The demands for expenditure have to be balanced against the available resources. A budget is, therefore, a financial plan for rationing scarce resources amongst various demands for expenditure. Over the last few decades, however, budgets have become extremely complex and pervasive. According to Gladstone “they are no longer affairs of arithmetic but in a thousand ways go to the root of prosperity of individuals, the relations of classes and strength of kingdoms”. Thus the concerns of budget makers are not just financial, that is, producing a balance between expenditure and revenues; rather these are economic, political, social and administrative in nature.

In this unit, we will discuss the meaning, characteristics and functions of budget. The three-fold classification of budget shall also be examined.

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## 7.2 BUDGET—MEANING

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A budget is a statement containing a forecast of revenues and expenditures for a period of time, usually a year. It is a comprehensive plan of action designed to achieve the policy objectives set by the government for the coming year. A budget is a plan and a budget document is a reflection of what the government expects to do in future. While any plan need not be a budget, a budget has to be necessarily a plan. It shows detailed allocation of resources and proposed taxation or other measures for their realisation. More specifically, a budget contains information about :

- i) plans, programmes, projects, schemes and activities—current as well as new proposals for the coming year;
- ii) resource position and income from different sources, including tax and non-tax revenues;
- iii) actual receipts and expenditure for the previous year; and
- iv) economic, statistical and accounting data regarding financial and physical performance of the various agencies and organs of the government.

A budget is, however, not a balance sheet (exhibiting total assets and liabilities) of the government on a particular date but refers only to information explained above. It is a financial blueprint for action and is, therefore, of great advantage to government departments, legislatures and citizens.

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### **7.3 CHARACTERISTICS OF BUDGET**

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The basic characteristics of government budgeting are as follows:

- i) There is a strong emphasis on expenditure control with itemised ceilings and sanctions. The French system of budgeting is largely based on this principle, viz. : a strong financial control system. For historical and administrative reasons, Indian budgetary system is also set in a framework of strong financial control. Although, after Independence, this feature has become diluted through various schemes of delegation of powers and decentralisation.
- ii) Another characteristic is the tendency towards incrementalism. The bulk of ongoing activities is left untouched. Only marginal adjustments are made in raising and allocating resources from one year to the other. In spite of various budgetary innovations, budgetary systems the world over are essentially incremental in nature.
- iii) There is usually no attempt to relate inputs to outputs or expenditure to performance and benefits. Any such attempt, if at all it is made, is limited to the economic function and the largest component of government activities, perse, are mainly expenditure-oriented.
- iv) Generally budgets are prepared for a time span of one year. Since budgeting presupposes planning it must, therefore, adopt a longer time frame.
- v) Some of the budgetary systems (Netherlands) reflect application of commercial principles to budget, including provision of depreciation allowances and in some systems, accrual-based accounting. The Italian budgetary system shows the availability of funds beyond the financial year with parallel operation of the preceding and current year's budgets.
- vi) In some countries, special accounts are maintained (Japan) and these are outside the budgetary process. In other countries, extra-budgetary devices of various types are resorted to

#### **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 are the components of a budget?

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- 2) Discuss the characteristics of government budget.

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## 7.4 FUNCTIONS OF BUDGET

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A budget is a powerful instrument in the hands of government. It has manifold objectives. Some of these are as follows :

### **Accountability**

In the early phase, legislative control and accountability were the primary functions of the government budget. This arose from the legislature's desire to control (impose, amend and approve) tax proposals and spending. The executive was accountable to the legislature for spending—within limits approved by the latter, under several heads of expenditure, and only for approved purposes. Similar accountability was to exist within the executive on the part of each subordinate authority to the one immediately above in the hierarchy of delegation. Accountability continues to be an important function of the government budget even today owing to its usefulness in budget execution and plan implementation.

### **Management**

Budgeting is an executive or managerial function. As an effective tool of management, budgeting involves planning, coordination, control, evaluation, reporting and review. Many of the budgetary innovations such as :

- functional classification,
- performance measurement through norms and standards,
- accounting classification to correspond to functional classification,
- costing and performance audit and use of quantitative techniques

have become important aids to management. Various budgetary systems like performance budgeting and zero base budgeting are specifically management-oriented systems.

### **Control**

Control essentially implies a hierarchy of responsibility, embracing the entire range of executive agencies, for the money collected and expenditure, within the framework of overall accountability to the legislature. In a democracy, control assumes new dimensions and gives rise to exceedingly difficult problems. The basic concern in a truly representative government is to bring about suitable modifications in the design and operation of the financial system so as to ensure executive responsibility to the legislature which is the law-making, revenue determining and fund-granting authority.

Legislative control would mean that the legislature can meaningfully, and not merely formally, participate in the formulation of broad policies and programmes, their scrutiny, approval and implementation through the annual budget. It also means that the legislature can effectively relate performance and achievement of the executive to the objectives and policies as laid down by it.

Members of the legislature are not always adequately acquainted with the complexities of financial administration, nor can they always understand the enormity of the vast scale of operations and therefore the level of funds required.

Various devices are, therefore, used to assist legislatures in exercising their legitimate powers over the executive. The Congressional committees of the United States and the Parliamentary Select committees of the United Kingdom and India help the legislature in exercising their control over the public purse. We shall be discussing in detail about the role of financial Committees in Unit 19 of Block 6 of this course. Statutory audit also examines the accounts and other relevant records to ensure that the moneys granted by the legislature are spent strictly in accordance with law. Also, audit tries to ensure that the government obtains value for the tax-payers' money and that the norms of economy, efficiency and effectiveness are observed.

### **Planning**

Budgeting provides a plan of action for the next financial year. Planning, however, involves the (i) determination of long term and short term objectives,

(ii) determination of quantified targets, and (iii) fixation of priorities. Planning also spans a whole range of government policies keeping the time factor and inter-relationships between policies in view. Planning envisages broad policy choices. At the level of projects and programmes, the choice is between alternative courses of action so as to optimise the resource utilisation. The goals of public sector, viz., (i) optimal allocation of resources, (ii) stabilisation of economic activity, (iii) an equitable distribution of income, and (iv) the promotion of economic growth are all pursued in an organisational context. In the short-run, achievement of these goals has to be co-ordinated by means of administrative and legal instruments among which budget policy and procedure are the most important. Planning in the budget process reflects political pressures as well as financial pressures and financial analysis.

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## **7.5 CLASSIFICATION OF BUDGETS**

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Information on the working of the budgetary process is obtained from the systems of classification. Since such a process has a multitude of functions and objectives, different types of classification are needed, either singly or in combination to serve the purpose of appropriation, programme management and review, evaluation of plan implementation and financial and economic analysis. Transactions of the government can be classified by

- objects such as salaries, wages etc.;
- organisation or department;
- functions such as defence, education, agriculture, etc.;
- their economic character such as consumption expenditure, capital formation, etc.

The system of classification of expenditure is a very important aspect of the budget for the fulfilment of budgetary functions. It is through the classification system that the managerial potential of budgeting process may be realised. Let us now discuss some of the most important classification systems. They are :

- Object-wise or line-item or traditional classification
- Functional classification
- Economic classification

### **Object-wise Classification**

Traditional budgeting ensures control of expenditure and the need to ensure accountability of the executive to the legislature as well as that of the subordinate formations of the executive to the higher echelons. The budget is divided into sections according to organisational units, departments, divisions and expenditure is detailed by each category such as salary, wages, etc. A typical classification would be as follows :

- 1) Salary
- 2) Wages
- 3) Travelling allowance
- 4) Office expenses
- 5) Machinery and equipment
- 6) Works
- 7) Grants-in-aid
- 8) Other charges
- 9) Suspense account

### **Merits**

- i) As already stated, the rationale for this type of classification was the need to facilitate control and accountability. Inter-agency, inter-organisation and inter-department comparison of expenditure could easily be made. This information would also be available on a time-series basis, that is, from year to year, so that the departments concerned could be pulled up if the expenditure trends, as revealed through this classification, were not satisfactory.

- ii) It shows clear allocation of funds. For example, what percentage of the expenditure is on salaries, travelling allowances, etc.
- iii) In times of financial stringency, this classification enables across-the-board cuts on specific heads such as travelling allowances, foreign travel etc.

**Demerits**

- i) The basic philosophy of budgets with this type of classification is that spending the budgetary allocation is in itself a virtue. Whatever the amount allocated to a particular object it has to be spent, without emphasis on the likely outcome of that expenditure. Since control is not related to performance, it easily degenerates into wastefulness and extravagance. Performance thus takes a back seat.
- ii) Emphasis is laid on procedural considerations, legality and regularity of expenditure and all the complex rules that are framed to satisfy regularity audit. Evaluation, justification for expenditure and obtaining value for money become only incidental.
- iii) Inadequate information is available about the government's objectives and programmes. The emphasis on control and accountability exerts an influence on the criteria which govern budget decisions. Programme control, contribution to development, programme co-ordination and efficient resource allocation are neglected.
- iv) Any duplication, redundant activities and expenditure are hard to detect and avoid.
- v) It is only the most pressing demands which receive attention of the budget makers. Policies, programmes and projects which have only long term benefits, usually get postponed year after year.

**Functional Classification**

Performance budgeting is based on a "conviction that the way in which revenue and expenditure are grouped for decision-making is the most important aspect of budgeting". A functional classification of the budget is necessary under the system of performance budgeting. The presentation of budgeted expenditure should, therefore, be in terms of functions, programmes, activities and projects. Such a classification is an aid to the managerial function of performance measurement relative to the costs incurred. The output of a programme/activity in terms of physical targets has to be related to the inputs required. These are translated into financial terms and shown as the budget provision asked for the implementation of the programme/activity. The scheme of functional classification is outlined below :

**FUNCTIONAL CLASSIFICATION**

Term	Definition	Examples
Function	A major division of governmental efforts which provides distinct services.	1) Education 2) Health 3) Defence 4) Agriculture
Programme	A segment of a function usually having an end identifiable with a major organisation.	1) Elementary education Secondary education Higher education Technical/Vocational education 2) National Malaria Eradication Programme 3) Development of High Yielding Crops
Activity/Project	A division of a programme into homogeneous types of work or schemes	1) Construction of school buildings Strengthening of laboratories 2) Purchase of seeds/fertilisers

Another example of a functional classification of roads will classify the system as :

- Function : Roads
- Programmes : 1) National Highways
- 2) Roads of Economic or Inter-State importance
- 3) Strategic Roads
- 4) State Highways
- 5) Major District Roads
- 6) Rural Roads

Activity/(under the Programme : National Highways) Project :

- 1) Maintenance of Roads
- 2) Construction of Bridges on the National Highways Km  
× 1.....to.....× 10
- 3) Restoration of Missing Links
- 4) Widening of Roads
- 5) Construction of Bye-pass
- 6) Grade Improvement etc.

The terms function, programme, activity and project have definite connotations; in practice, however, these can be quite flexible, the only requirement being that these terms should be used in a consistent manner over the entire span of a departmental budget and also as between different departments of the government.

This type of classification provides information about the nature of sources of the government and the share of public expenditure directed towards that particular budgetary control—administrative accountability.

An important point to be noted is that the total budget provision, however classified, has to be the same; as it is the same budget which is submitted to the legislature for approval.

### **Economic Classification**

The budget of the government has an impact on the economy as a whole. Because of its sheer magnitude, receipts and expenditure of the government and various policies that are articulated through the budget, are easily the most significant factors that can and do change the very nature, content and direction of the economy. It is, therefore, important to group the budgetary provisions in terms of economic magnitudes, for example, how much is set aside for capital formation, how much is spent directly by the government and how much is transferred by government to other sectors of the economy by way of grants, loans, etc. Economic classification categorises government's total expenditure into meaningful economic heads like investment, consumption, generation of income, capital formation etc. According to the Economic and Social Council of the United Nations (Economic classification provides) "an analysis of the transaction of Government bodies according to homogenous economic categories of transactions with the other sectors of the economy directly affected by them". This analysis is contained in a separate document called Economic and Functional Classification of the Central Government Budget, and is brought out by the Ministry of Finance. A broad categorisation is as follows :

### **Economic Classification of Total Expenditure**

- 1) Consumption Expenditure
  - a) Defence b) Other Government Administration
- 2) Transfer Payments (current)
  - a) Interest Payments b) Subsidies c) Grants to States and Union Territories
  - d) Others
- 3) Gross capital formation of budgetary resources
  - a) Physical Assets b) Financial Assets

- 4) Others
- 5) Total Expenditure

An annual comparison would show whether the expenditure on capital formation is increasing or declining. A decline would be due to increase either in consumption expenditure or in the transfer payments, say interest.

## 7.6 BUDGET—AN ILLUSTRATION

The Budget 1992-93 of the Government of India is reproduced below. It indicates brief receipts and disbursements along with broad details of tax revenues and other receipts. A broad break-up of expenditure—plan and nonplan, capital and revenue is also given. The excess of government's revenue expenditure over revenue receipts constitutes revenue deficit of government. Taking into account the capital expenditure and the capital receipts also, there is a gap of a year between receipts and expenditure. This total borrowing requirement of the government from all sources equals the fiscal deficit. This is the difference between the total expenditure of Government by way of revenue, capital and loans (net of repayments) on the one hand and revenue receipts of governments and capital receipts which are not in the nature of borrowing but which finally accrue to the government, on the other.

### बजट का स्तर Budget at a Glance

		(करोड़ रुपए) (In crores of Rupees)			
		1990-91 वास्तविक Actuals	1991-92 बजट अनुमान Budget Estimates	1991-92 संशोधित अनुमान Revised Estimates	1992-93 बजट अनुमान Budget Estimates
1.	राजस्व प्राप्तियाँ	54954	67529	66549	75688
2.	कर राजस्व				
3.	कर-भिन्न राजस्व	42978	52500	50006	56456
4.	पूंजी प्राप्तियाँ	39015	38174	39521	38010
5.	ऋणों की वसूली	5712	5666	6261	6491
6.	अन्य प्राप्तियाँ	...	2500	2500	2500
7.	उधार और अन्य देयताएँ	33303	30008	30760	29019
8.	कुल प्राप्तियाँ	93969	105703	106070	113698
9.	आयोजना-भिन्न व्यय	76198	79697	80070	84475
10.	राजस्व खाते पर	60850	64315	66696	71233
11.	पूंजी खाते पर	15348	15382	13374	13242
12.	आयोजना व्यय	29118	33725	33032	34612
13.	राजस्व खाते पर	12666	17068	16934	18337
14.	पूंजी खाते पर	16452	16657	16098	16275
15.	कुल व्यय	105316	113422	113102	119087
16.	राजस्व व्यय	73516	81383	83630	89570
17.	पूंजी व्यय	31800	32039	29472	29517
18.	राजस्व घाटा	18562	13854	17081	13882
19.	बजटीय घाटा	11347	7719	7032	5389
20.	राजकोषीय घाटा	44650	37727	37792	34408

21. भारतीय रिजर्व बैंक द्वारा केन्द्रीय सरकार को दिए गए निवल ऋण में वृद्धि #	Increase in net RBI Credit to Central Government #	14745	7719	8800	5389##
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# भारतीय रिजर्व बैंक द्वारा केन्द्रीय सरकार को दिए गए ऋणों में हुई अन्य घट-बढ़ सहित। # Including other variations in Reserve Bank of India's credit to Central Government.

## इसका अलग से अनुमान नहीं लगाया गया। ## Not independently estimated.

**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 are the functions of a budget?

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2) What is object-wise classification of budget? Discuss its demerits.

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3) Explain economic classification of budget.

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**7.7 LET US SUM UP**

A budget is an annual financial statement containing a forecast of revenues and expenditures of the government for a financial year. It shows a break up of expenditure, proposed taxation or other measures for raising resources. Budget is usually for one year, is incremental in nature and expenditure-oriented. As discussed in the unit, budget is a powerful instrument with manifold objectives in the hands of government. Primarily it was viewed as an instrument of legislative control and accountability. In the modern times, however, budgeting has become management-oriented and various budgetary innovations have specific managerial objectives. Budget also serves as a vehicle for implementing the developmental plans of the nation.

Information on the working of the budgetary process is obtained from the systems of classification. Transactions of the government can be classified by objects such as salaries, wages etc; by function as defence, agriculture, industry etc., or by their economic character such as consumption, capital formation etc. These are respectively known as object-wise classification, functional classification and economic classification.

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## 7.8 KEY WORDS

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**Accrual-based Accounting :** An accounting system where a system of charging income and expenditure to the period in which they are earned or incurred is followed, rather than to the period in which they are actually received or paid.

**Accountability :** Responsibility of the various agencies of the government for the proper management of funds allocated.

**Depreciation Allowance :** Allowance provided for the diminution or reduction in the value of an asset due to use and/or lapse of time.

**Economic Classification :** Grouping the budgetary provisions in terms of economic magnitudes such as consumption expenditure, transfer payments, capital formation, etc.

**Functional Classification :** Presentation of the budgeted expenditure in terms of functions, programmes, activities and projects.

**Incremental Budgeting :** A system of budgeting in which the bulk of expenditure on the on-going activities of the government is left untouched, only marginal adjustments (incremental) are made in raising and allocating revenues.

**Line-item Classification :** The system of classifying expenditure by organisations (Ministries and departments of the government) and objects of expenditure such as salary, transport, material contingencies etc.

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## 7.9 REFERENCES

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

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

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## 7.10 ANSWERS TO CHECK YOUR PROGRESS EXERCISES

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### Check Your Progress 1

1) Your answer should include the following points :

A budget essentially includes the information about :

- plans, programmes, projects, schemes and activities, current as well as new proposals for the coming year,
- resource position and income from different sources including tax and non-tax revenues,
- actual receipts and expenditure for the previous year, and
- economic, statistical, and accounting data regarding financial and physical performance of the various agencies and organs of the government.

2) Your answer should include the following points :

- Strong emphasis on expenditure control with itemised ceilings and sanctions.
- Tendency towards incrementalism.
- No attempt to relate inputs to outputs or expenditure to performance benefits.
- Short time-span of one year.

**Check Your Progress 2**

- 1) Your answer should include the following points :
  - Accountability
  - Management
  - Control
  - Planning
- 2) Your answer should include the following points :
  - Object-wise classification of budget is one where the budget is divided into sections according to organisational units, departments, divisions etc. and expenditure is indicated by each category like salary, wages, travelling allowances etc.  
Demerits of classification are :
    - Control is not related to performance.
    - Procedural considerations, legality and regularity of expenditures, complex rules are given importance; evaluation and justification for expenditure become incidental.
    - Inadequate information is available about objectives and performance of government.
    - Duplicate, redundant activities and expenditure are hard to detect and avoid.
- 3) Your answer should include the following points :
  - Economic provisions in terms of economic magnitudes should for example, indicate how much is set aside for capital formation, how much is spent directly by the government and how much is transferred by government to other sectors of economy by way of grants, loans etc.
  - It categorises government expenditure into meaningful economic heads like investment, consumption, generation of income, capital formation.