WORKING PAPER NO: 536

Should Revenue and Capital Account be Shown Separately in the Union Budget?

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Year of Publication – January 2017

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Abstract

Should India retain the distinction between revenue and capital classification in its Budget format? There is a constitutional provision for distinguishing between the two expenditures, revenue and capital, and various committees appointed by the Government of India have expressed their opinion to retain distinct classification.

International experience does not suggest that distinction of expenditure is an absolute necessity. In fact, many advanced countries that were earlier in the emerging/developing stages maintained a distinction between revenue and capital account to allow for better resource allocation. Some of these countries continue to maintain the distinction while others have discontinued with the practice of having separate classification.

The distinction between revenue and capital budget helps in providing transparency in the amount that is being borrowed by the Government. As different departments of the Government are involved in receipts and expenditure, a clear demarcation helps in independent estimation of different variables in the Budget.

Keywords: Revenue Expenditure, Capital Expenditure, Union Budget

[1] The authors would like to thank Ajay U. Pai for his research assistance.

The Government of India, on September 21, 2016, announced in its annual Budget Circular that Plan and non-Plan Expenditure budgets would be merged in the Union Budget 2017-18. Over the years, expenditure on schemes sponsored by the Planning Commission were covered under the Plan expenditure as also, public expenditure on asset formation in the economy. Thus, there emerged a view among policy-makers and analysts that Plan expenditure is good and non-Plan is bad, like good and bad cholesterol, given the fact that expenditure is an essential component of any budget exercise.

Consequently, both the Centre and state governments started recording higher Plan expenditure over the years. This led to non-Plan expenditure such as maintenance of assets, health and education services being neglected. In view of the abolition of Planning Commission, the distinction between Plan and non-Plan would generally be dispensed with now in case of Central Government.[2] However, the issue is that should the budgetary practice that continues to make a distinction between revenue and capital account also be discontinued.

There is a historical precedent for conception and use of capital budgets, which record only capital expenditure and incomes, in a country's national budget – "Golden Fiscal Rule" (GFR) – stating that any borrowed fund must be dedicated solely for capital-spending projects. The GFR, however, was a late 1930s European development which led to bifurcation of expenditure into revenue and capital spending. The budgets of various countries that implemented GFR continue to retain a classification like capital and recurrent[3] budgets. While the colonial powers of Europe extended this practice to their colonies, by the 1940s, most countries followed the distinction.

However, after the Second World War and contraction of defense budgets, advanced countries have slowly reverted back to the older format of creating a unified national budget that has both recurrent and capital expenditure. Research indicates that pitfalls of arbitrary classification of expenditure, and need for better resource allocation and implementation of capital projects, points towards the benefits of integrating the two kinds of expenditure. This development, however, has not been generally adopted by developing countries.

[2] However, state governments can continue with Plan and non-Plan distinction, as Economic and Social Planning is in the Concurrent list (7th Schedule, Item 20), and all states continue to have State Planning Boards. Further, Plan expenditure for SC/ST for major schemes is a statutory requirement unless the relevant Acts are amended. However some kind of planning is critical in the form of medium term budgeting.

[3] Similar to revenue budget in India.

The Study is presented in the following 4 sections, apart from the above introduction. In Section II, a brief review of literature is presented. In Section III, the cross-country experiences with respect to the classification is discussed. In Section IV, India's position in the context of distinction between revenue and capital expenditure is highlighted. Finally, in Section V, some conclusions and recommendations are presented.

Section II: Brief Review of Literature

The Asian Development Bank (1999) defines dual budgeting as the dual process of budget preparation, whereby the responsibility for preparing the investment or development/capital budget is assigned to an entity different from the entity that prepares the current budget.

According to Planning Commission (2012) there should be a classification between revenue and capital expenditure for attaining greater control over public debt and its utilization in compliance with FRBM (FRBM Act, 2003). Also, because of transparency that separation brings in budgetary operations, a distinction between expenditure encourages proper allocation of borrowed funds. In a similar vein, the Government Financial Statistics Manual (2001) of IMF also recommends separate disclosure of capital and current grants.

Similarly, OECD (2001), and Salvatore and Daniel (1999) recommend that a clear distinction between current and capital expenditures is necessary, for the purposes of analysis and efficient policy decision-making. The capital expenditure component of the budget and the forward costs of budgeted projects helps in analysis of budget, even if shown in an annex to the budget, or in summaries. Similar arguments were also presented by two Reports of GOI (Chairman: A.K. Mukherjee, 1972) and GOI (Chairman: Ashok K. Lahiri, 2004). A proper distinction between revenue and capital expenditure is based on the criteria laid down in Classification of Government Transactions in Accounts and Plan report, which defined capital expenditure as expenditure on acquisition of assets of material with permanent character. This classification is also provided to recognize the Union Government as transferor and states as transferee, as well as analyzing the details for policy prescriptions.

The World Bank (1998), and Stevens (2004), suggest that there should be a clear distinction between planning process, which is not particularly observed in developing economies. A failure to link planning with budgeting results in poor macro, strategic and operational outcomes in developing countries. The narrow separation between planning (on investment activities) and budgeting (on allocation of funds and resources) generates unpredictability of funding and dual budgeting where budgeting is not treated as policy-based exercise. In case of dual budgeting, separating development and recurrent budgets usually leads to development budget having a lower hurdle for entry. In view of this dichotomy in preferences, a unified structure is more preferred.

Sarraf (2005) notes that dual budgeting originated first in European countries and lasted for a short period during the World Wars. It was introduced in the late 1930s in order help governments to allocate borrowed funds specifically for capital expenditures as per the golden rule. However, soon after the Second World War, the two budgets were integrated as the governments in advanced countries reduced use of borrowed funds as a result of massive postwar reconstruction work and increased recurrent expenditures, along with the growing relevance of the Keynesian model of linking government spending and size of budget deficit and borrowing requirements to both fiscal and monetary policy. Existing dual budgeting, accounting, and reporting systems do not provide for a comprehensive analysis in the planning and budgeting of government operations or in the evaluation of their outcomes and results. Government accounting and banking rules may differ not only between recurrent and capital budgets, but also between two recurrent budgets, one financed from domestic and the other from external sources. Most country-specific public expenditure reviews by the World Bank, and individual technical assistance reports by the IMF, strongly advise integration of the recurrent and development budgets in client countries.

However, donor practices have tended to reinforce dual budgeting practices. Since donors have traditionally focused on capital investments, desire to attract donor funding gives a country a strong incentive to maintain a separate development budget process. This explains that dual budgeting leads to weak public finance management in developing countries.

Shah (2007) observes that capital budgets in governments have multiple objectives: as instruments of compensatory fiscal policy; as windows on the net worth of public bodies; and as vehicles of development, particularly in the area of economic infrastructure, through greater reliance on debt than on conventional sources of financing. Therefore, governments in the past have introduced one or more of these practices, depending on the context. In the developing world, however, where many governments still are on the edge of financial instability, debate continues about capital budgets and their equivalents. Thus, it may be more useful to have capital budgets at local rather than central levels of government as the main problem with the capital budget has been that its implementation was never in line with the conceptual framework.

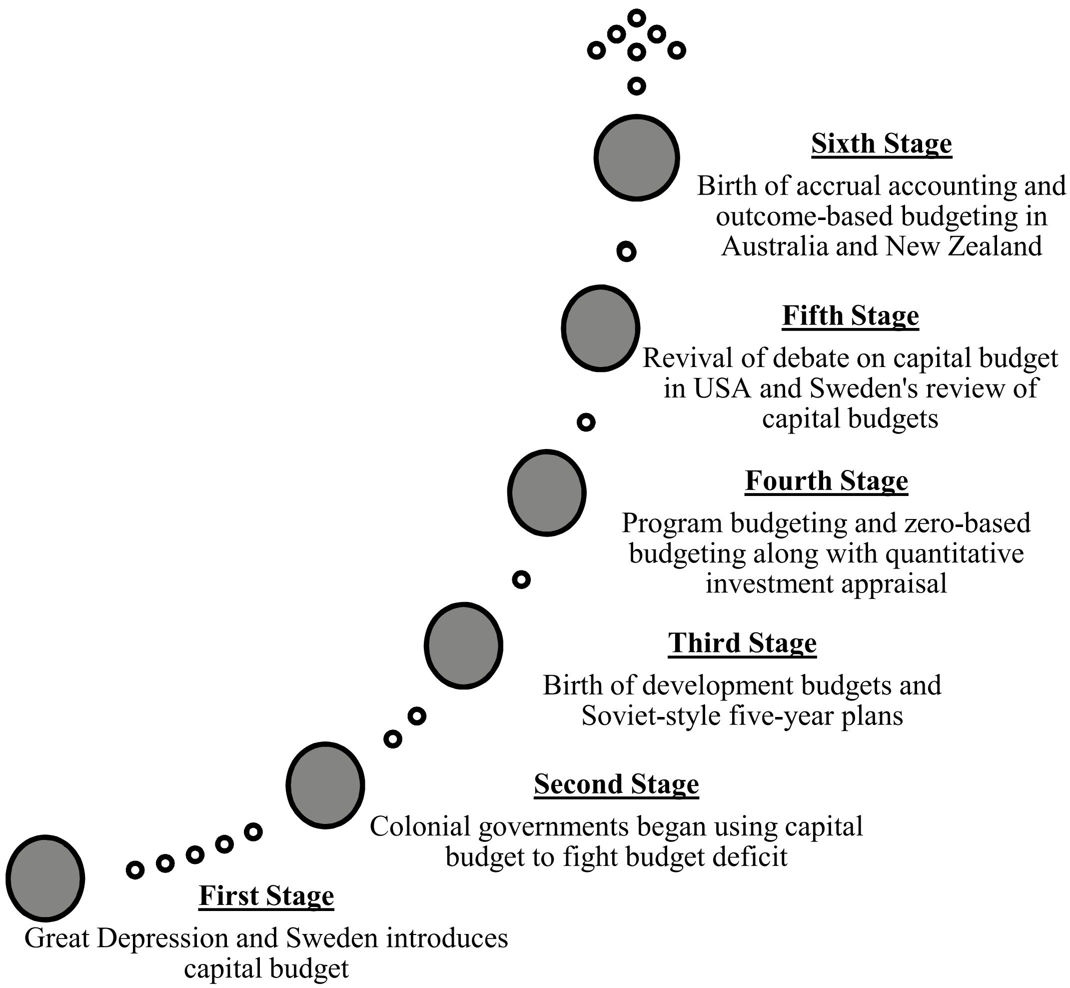
Jacobs (2008) explains that dual budgeting in African, Latin American and Middle-Eastern countries is largely credited to the national planning process that was existent in France, Spain and Belgium, who were the strongest colonial powers in these regions. Spackman (2002) suggests that Ministry of Finance in developed countries prepare both the revenue and capital budget as it is familiar with the spending unit’s activities. And Jacobs (2009) shows that there is international uniformity when it comes to an opinion on measurement of capital expenditure. Capital spending pertains to purchase, improvement and/or rehabilitation of physical assets with a useful life of more than one year.

III. Cross-Country Experience

The development of public finance and expenditure management compelled countries to prepare separate revenue and capital budgets and record the expenditure and incomes under two categories separately. The application of GFR would also encourage countries to assign borrowed funds only for the use of capital-spending projects which furthered the demands for preparation of separate budgets.

The dual budgets mainly started after the Great Depression (Figure 1).

Figure 1: Six Stages of Capital Budgeting[4]



The budgetary practices of countries differ on the basis of preparation, presentation and accounting techniques adopted by the respective governments. Some of the categories are as follows: [5]

a. In the first category, accrual accounting and budgeting has replaced cash accounting and therefore there is a distinction between operational and investment budgets. Australia, Chile, and New Zealand are some examples, including the United Kingdom which has adopted resource accounting and budgeting since fiscal year 2000-01.

[4] Complied by Ajay U. Pai based on Jacobs (2008)
[5] Closely follows Shah, 2007, p. 5.

b. The second category of countries show current and capital transactions in national accounts but under accrual system. The budget, however, does not make any such distinction. The United States falls into this category and the distinction is used for analytical purposes, and extensive data are presented on capital formation.
c. Denmark falls into the category of countries that now have investment budgets in place of capital budget. Japan, the Republic of Korea, and Southeast Asian countries have special investment budget that display selected features of capital budgets.
d. In many developing countries, governments have developmental budgets of a hybrid character which forms the next category. Only some capital outlays are included in these budgets; the receipts include loans received for both capital and current spending.
e. India forms another category of countries that have a capital budget as well as a revenue budget.

Over time, other types of budgetary practices have evolved. For example, the U.K. government reintroduced the GFR in 1997 of limiting capital expenditures to the size of borrowing to manage budget deficit. But this did not create any type of dual budgeting. However, the rule was abandoned in 2008/09.[6]

In the United States, periodic recommendations were made for the introduction of a separate capital budget. Expectations that resource allocation may favour "bricks and mortar" have stalled these recommendations. However, the budget documents presented a special analysis of investment (capital) expenditures.[7]

Current International Techniques of Budgeting

Most OECD countries operate on integrated capital and revenue budgets (Webber, 2007). The reason they do so is:

i) Difference between capital and revenue expenditure is often arbitrary and subjective;
ii) Effective resource allocation is possible with a single, unified framework.

New Zealand, United Kingdom and Norway have developed highly sophisticated strategies to manage capital assets, and their expenditure as well as the revenue expenditure associated with these assets.

[6] Truger, 2015, p. 34 for more on the abandonment of GFR by UK.
[7] Premchand, 1983, p. 302.

Another important development has been the shift of focus from cash-based to accrual-based accounting of assets and their expenditure[8].

In other developed countries, although capital and revenue expenditure are classified separately in annual government budget as well as in reporting and accounts, they are broken down into several program items. Presentation, debate and approval of these items on the budget are done as a whole in the Parliament, without making distinctions between the two broad kinds of expenditure revenue and capital[8].

Countries such as Jamaica, Namibia, Papua New Guinea, Sierra Leone, Gambia and others have arranged separately prepared revenue and capital budgets in unified documents for presentation to their legislatures[8].

In Guyana and Lesotho for example, there are two separate sections for the recurrent budget classified on a program and expenditure basis, and the development budget classified on a program basis that are presented in a single unified budget document. However, there are many countries where different budget documents are forwarded to legislature that lack specific program or expenditure object classification. There are still others such as Tanzania and Uganda that have integrated the recurrent and development budgets in many aspects, but with a separation in presentation and recording in documents[9].

IV. Practice in India

In the 1930s, government of undivided India introduced a capital budget to reduce a revenue deficit by shifting some items of expenditures from the current budget. It was believed that the burgeoning budget deficit did not reflect well on the creditworthiness of the colonial government. The introduction of a dual-budget system provided a convenient way to reduce revenue or current account deficits while providing a rationale for borrowing.

[8] Jacobs (2009)
[9] Sarraf (2005), p. 14.

Later, the Constitution also incorporated the need for revenue and capital expenditures to be shown separately in the budget. Article 112 (2) requires that "The estimates of expenditure embodied in the annual financial statement shall show separately –

(a) The sums required to meet expenditure described by this Constitution as expenditure charged upon the Consolidated Fund of India; and
(b) The sums required to meet other expenditure proposed to be made from the Consolidated Fund of India, and shall distinguish expenditure on revenue account from other expenditure."

The Expert Group constituted by the Government of India on 'Classification System for Government Transactions' (Chairman: Ashok K. Lahiri, 2004) observed that distinct exhibition of expenditure on revenue and capital accounts "cannot completely" be given up even though this distinction leads to dispersal of programme costs.

Constitutional Assembly discussions on the separation of expenditure

Some of the earliest Constitutional Assembly of independent India had sparked off spirited debate on the Constitutional necessity to separate revenue and other expenditure. The following was pointed out by B. Das[10] from Orissa's constituency in the Assembly held on June 8, 1949 with respect to two major aspects behind the idea of separate expenditure documents –

- Government borrowing was ₹ 26 crore to run its normal expenditure for the year 1949-50. That meant that every year a crore of Rupees was being added to the interest charges which under the article were going to be a charged on the Consolidated Fund of India. Loans and borrowings were the only way to mitigate normal expenditure necessities.
- Public debt in India rose by ₹ 20-30 crore annually since 1938-39 and it was still extensively high in 1949.

Evolving Practice of Budgeting

The Government of India's Estimates Committee (Chairman: Balvant Ray G. Mehta) in its Twentieth Report[11] in 1958, expressed a viewpoint on the system of classification that was being followed at the time. The system conformed to the needs of accountability but did not assist in program formulation and execution. There was a desire to ensure economic classification is adopted by not only the Central Government, but also by State Governments, public undertakings and the private sector for better accuracy in forecasts to support the formation of a "national budget".

[10] For more, please refer to Constituent Assembly of India - Volume VIII, Parliament of India.
[11] Estimates Committee Budgetary Reform, April 1958

The committee, Team of Reforms in the Structure of Budget and Accounts (Chairman: A.K. Mukherjee, 1972) established the criteria that continues to define the current system of classification between revenue and capital expenditure, where capital expenditure leads to ownership of capital assets.

The General Financial Rules of 2005 and the Government Accounting Rules also define capital expenditure as "Expenditure incurred with the object of increasing concrete assets of a material and permanent character."[12]

The High Level Expert Committee on Efficient Management of Public Expenditure (Chairman: Dr. C Rangarajan, 2012) expresses that it is in favor of continuing the Revenue-Capital classification. Capital expenditure should relate to creation of assets and be determined by ownership criterion. The Committee notes that separation provides greater control over public debt and its utilization. The implementation of the GFR, a rule followed by many countries, requires that current account is balanced over a period of time, such as an economic cycle, and Governments borrow only to invest in capital spending projects. This would mean that debt financing of capital expenditures results in intergenerational equity. The Committee notes that this distinction would facilitate strategic allocation and create a framework for use of borrowed funds for capital expenditure. Consequently, the disclosure of expenditure in separate documents would facilitate efficient economic analysis of spending and generate information on capital formation.

The Fourteenth Finance Commission also stressed that it was important that Central and State governments follow the general definition for revenue expenditure. The Commission went on to state that the "existing classification of revenue and capital expenditure cannot be disturbed in an ad-hoc manner", also recommending a comprehensive study on the need for classification. It concluded that there would be widespread implications for Central and state governments' finances in the event of any disturbance to the said classification.[13]

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[12] Rule 291(1), General Financial Rules, 2005.
[13] Government of India, 2014, Fourteenth Finance Commission Report, p. 198.

Current Budgeting Approach in India

In the recent budget circular,[14] the Ministry of Finance noted that a clear distinction between capital and revenue expenditures is essential for analytical purposes, transparency, and efficient policy decision-making. The distinction is fundamentally important for assessment of operating costs of government and investments made by it along with measuring the efficiency of government activities. Moreover, developing a performance-oriented approach requires separation of running costs from capital expenditures.

Moreover, the Fiscal Responsibility and Budget Management Act, 2003 (FRBM) clause 2(e) indicates two components of expenditure in the Government – (a) the revenue expenditure, and (b) those which result into increase in assets of the Government. FRBM aims to ensure inter-generational equity in fiscal management and long-term macro-economic stability by achieving sufficient revenue surplus. Hence, FRBM appears to imitate the opinion of the GFR on borrowed funds and implicitly aims at balancing the current and capital sides of the budget.

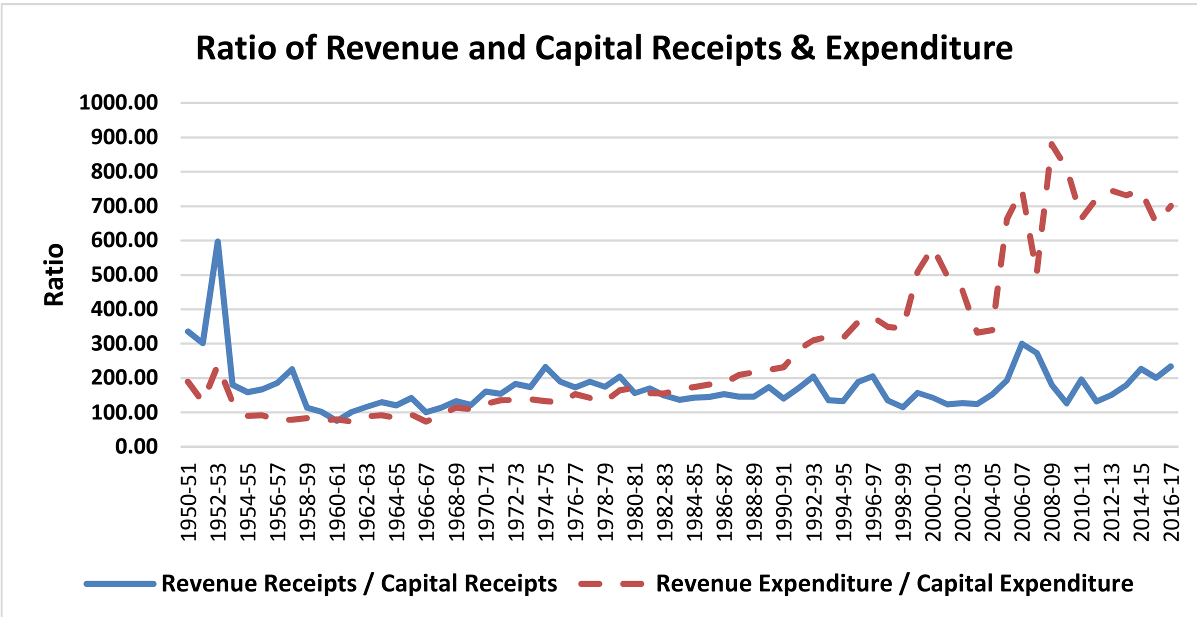
A logical corollary is as to what should be the ratio of revenue and capital expenditure? This is indeed a difficult policy issue and would change with time and state of economic development, and therefore be difficult to predict for any specific country. In initial stages of development and growth, capital expenditure would be high for developing countries, and lower than the earlier years in advanced and developed countries. That, probably, is the reason that investment as proportion of GDP is much lower in advanced countries than in emerging countries. Further, unlike private sector, because government has an important and infinite revenue tool, taxation, it would be difficult to prescribe a standard ratio for Government budget. Similarly, as Government is the only agency in the country that can provide lead in high investment public utility projects, like dams, hospitals, educational institutions, a restrictive prescription may not be in the interest of national welfare and economic growth, because government capital projects, after a gestation period, yield an income stream that adds to revenue receipts of the government.

In India, the ratio of revenue to capital expenditure has been rising since 1956-57 but the volatility has been the largest in the last decade (Figure 2). Similarly, the ratio of revenue to capital receipt has

[14] Budget Circular 2017-18, dated Sept 21, 2016.

generally been stable except in the last two decades reflecting the trend in government borrowings. The trend in plan expenditure which is assumed to be oriented towards capital formation has been lower than the non-plan expenditure (Figure 3). However, the classification between Plan and non-Plan expenditure has generally not been very transparent. [15]

Figure 2



Source: Government of India and Reserve Bank of India

The increase in capital receipts and revenue expenditure is significantly larger than revenue receipts and capital expenditure (Table 1).

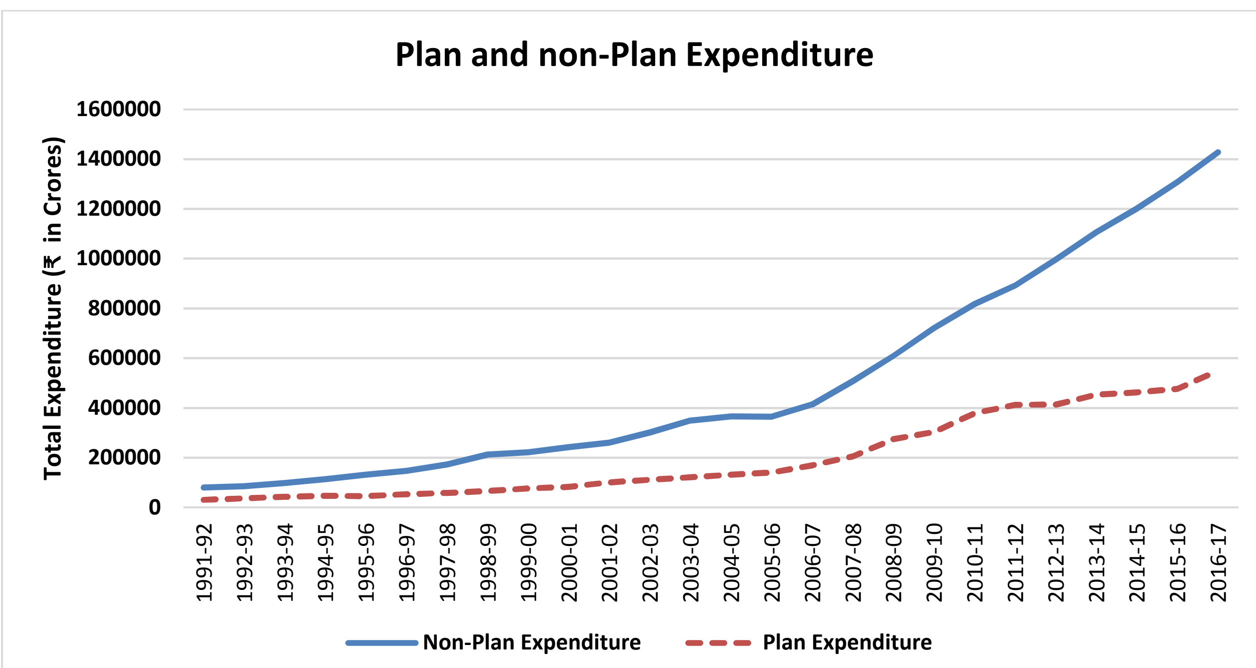
[15] It must be noted that the classification between Plan and non-Plan expenditure is blurred, especially with respect to defence expenditure. Defence expenditure in India does have an element of planning and the medium term budgetary framework is used for purchase of defence equipment. Illustratively, the discussion in Fourteenth Finance Commission Report on Defence Expenditure, GOI, 2014, p. 70.

Table 1: Five-Year Averages of Inflation-Adjusted Growth Rates of Revenue and Capital Accounts

Year	Revenue expenditure	Capital expenditure	Revenue receipts	Capital receipts
1951-56	6.8	33.3	6.4	47.3
1956-61	8.7	12.1	7.9	31.4
1961-66	13.5	9.5	15.5	1.6
1966-71	3.6	-0.6	1.3	1.4
1971-76	8.3	7.7	9.8	7.4
1976-81	7.5	1.9	1.4	7.5
1981-86	10.2	9.0	9.2	11.1
1986-91	8.0	2.5	5.8	6.7
1991-96	3.4	-6.1	4.9	0.7
1996-01	9.0	0.1	6.2	14.8
2001-06	5.5	7.6	8.5	2.6
2006-11	11.9	16.0	11.5	14.6
2011-16	3.2	3.8	4.1	5.0

Source: Government of India and Reserve Bank of India

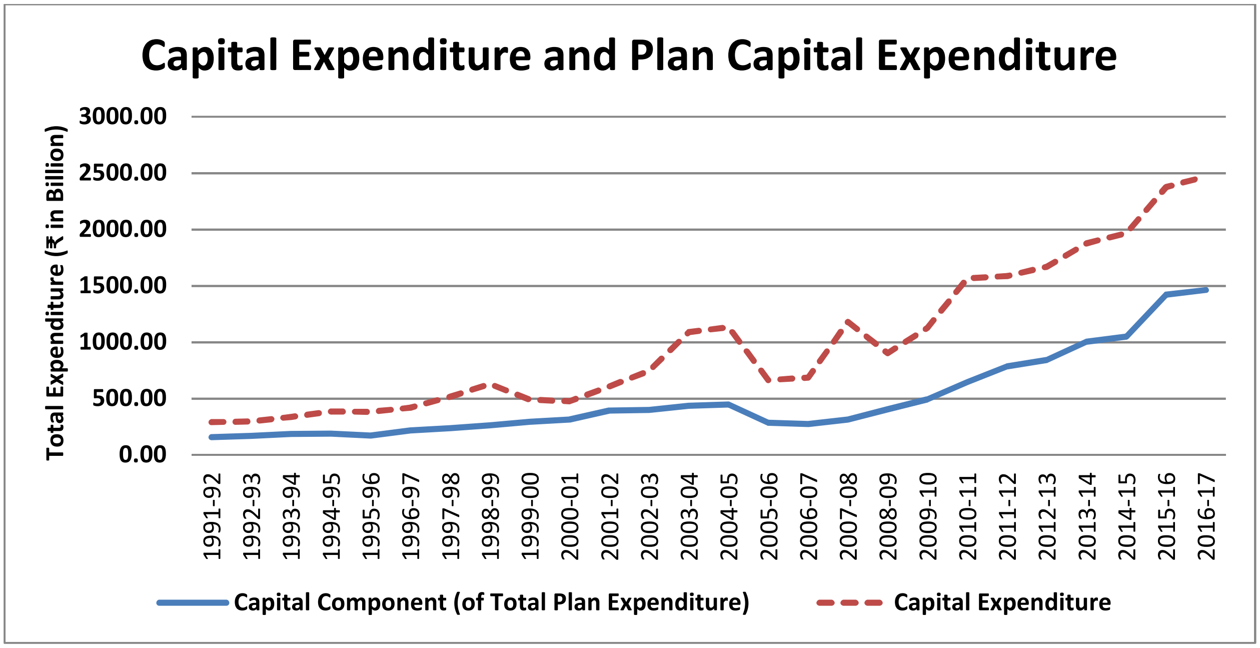
Figure 3



Source: Government of India and Reserve Bank of India

Further, there seems to be a divergent trend in Budget capital expenditure and Plan Capital expenditure over the years (Figure 4).

Figure 4



Source: Government of India and Reserve Bank of India

Another relevant issue in this context is sustainability of borrowings over a period of time. This aspect which pertains to placing limit on borrowing is covered under debt sustainability literature for which there has been substantial but inconclusive research.[16] The most simple, useful and intuitive formula is to ensure the growth rate of the economy is higher than the rate of interest payments made through the budget, following the famous Domar Rule of 1944.

V. Conclusion and Recommendation

In conclusion, the distinction between revenue and capital account is important and should be retained in India. The Constitution (Article 112 (2) (b) for the Union and Art 202 (2) (b) for States) points to the distinction between revenue and capital expenditure. International experience also suggests that the distinction is useful. Empirical evidence of advanced countries, reveals that when they were in emerging/developing country stages, they had a distinct category of revenue and capital account. The

[16] Kaur and Mukherjee, 2012; Singh, 1999.

distinction helps in clearly showing to the public as to how much is being borrowed by the Government and with what maturity levels – when it comes to treasury bills, securities, external and domestic borrowings.

The distinction also provides transparency as to how much of the borrowed amount is being redirected into asset building. The Government, because of transparency, has to resist the temptation of channelizing borrowings to payments of pensions, salaries and subsidies or other items of revenue expenditure which are popular but do not lead to long term capital formation.

As different departments of the Government are involved in preparing receipts and expenditure budget, a clear demarcation helps in independent estimation of different variables in the Budget. However, a clear definition of variables would help in uniformity of classification of expenditure. Capital and asset creation is one segment of the Government budget which is prone to leakages and corruption. Therefore, this component of expenditure has to be regularly evaluated and audited and hence should be kept separate. To achieve the clear demarcation of revenue and capital expenditures, program wise budgeting with the help of modern budgeting tools is necessary as is being used by Australia and USA. An independent agency to carry out continuous assessment of expenditures, particularly of Capital Items may go a long way to support the legislature and other stake holders in the exercise.

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