Chapter 14

Institutional Changes and Reforms

14.1 For effective functioning of the finance commission and for proper implementation of the recommendations made, certain institutional changes, as mentioned below, are necessary. The observations made in this chapter must be read along with the suggestions that we have made in other chapters.

A Permanent Secretariat for the Finance Commission

14.2 Finance commissions are set up as temporary bodies every five years or so for a specific duration and are wound up as soon as they submit their recommendations. The temporary character of finance commissions necessitates that each time a finance commission is constituted, all administrative and infrastructural arrangements such as hiring of office building, appointment of personnel, procurement of equipment etc. are made afresh. It also necessitates that each commission collects data and information afresh due to which considerable time lapses before the commission can start functioning in an effective manner.

14.3 The process of setting up of the Twelfth Finance Commission commenced with the creation of an advance cell under an Officer on Special Duty in a small rented portion of Lok Nayak Bhawan with effect from 01.06.2002 for making preparatory arrangements for setting up of the Commission. The orders sanctioning posts to provide personnel for the Commission took some time and were issued on 12.4.02, 12.7.02 and 26.02.03. Two floors measuring approximately 16000 sq.ft. were hired in the Jawahar Vyapar Bhawan (STC building) at Tolstoy Marg, New Delhi to house the Commission. The process of appointment of staff and of furnishing and interior decoration of the hired premises was started by the advance cell more or less simultaneously. The Commission was constituted vide the Presidential notification dated 1.11.2002. By the end of 2002, however, it had been possible to fill up only 19 out of the 141 posts sanctioned for the Commission and only about 4000 sq.ft. of space was available for occupation in Jawahar Vyapar Bhawan. It took another six months till the end of June 2003 for the work of furnishing and interior decoration of the premises to be completed. Thus, there was a time lag of about nine months between hiring of the space and its becoming fully operational. Further, the Commission was constrained by rigid and elaborate government rules for appointment/deputation and lack of flexibility in offering higher pay scales or incentives to attract the right personnel for essentially short period appointments, as a result of which only 111 out of the 141 sanctioned posts could be filled up even by March 2004. The first eight months after constitution of the Commission were, therefore, spent on setting up administrative and infrastructural facilities during which little attention could be paid to the substantive functions of the Commission.

14.4 The finance commission division (FCD) set up in Ministry of Finance is expected to provide support to the new finance commission in the form of continuity of data, as soon as it is set up. The Eleventh Finance Commission (EFC) observed that the sole job of the FCD had been to monitor the expenditure and release of upgradation grants to the states and that it had not devoted itself to building a database on central/state finances or been a conduit for research in specified areas. It had only been keeping the records left over by previous finance commissions, without proper referencing. The Commission recommended that there should be a permanent secretariat with core research staff placed under an officer of the level of an additional secretary to government of India and that this would facilitate coordination with the ministries/ departments of the government of India as also with the state governments at appropriate levels. This would also ensure an up-to-date building of data base on centre-state finances and documentation, which could be used by the commission when it is constituted. Unfortunately, the recommendations of the EFC in regard to creation of a permanent secretariat have not been taken seriously. In spite of successive finance commissions stressing the importance and need for constant upgradation of data and organizing studies relevant to the working of the future commissions, not much attention seems to have been paid by the Ministry of Finance to this pressing need. The FCD remains a small cell in the Ministry of Finance and does not appear to be capable of providing the necessary assistance to the commission. It continues to maintain a separate identity even after the constitution of a new finance commission and is only accountable to the Ministry of Finance. In relation to our work, it was noticed that the division had not compiled data relating to debt due to which we not only faced major difficulties but spent considerable time in collection of such data. Further, the division had not undertaken any compilation of data or analysis of the working of state undertakings. Even the information regarding union finances in the prescribed proforma and notes on issues could only be received from the Ministry of Finance after considerable delay and constant persuasion, raising questions over the precise role of the FCD. Considering that the division has not been strengthened, as recommended by the previous commissions and heavy responsibilities were expected to be discharged by the division, these failures were understandable.

14.5 The terms of reference of the finance commission were initially confined to its role under the Constitution viz., the distribution between the Union and the states of the net proceeds of taxes and the grants-in-aid to the revenues of the states. However, over time, more and more items have been added to the terms of reference of finance commissions. The most notable among these are the additional terms arising from the 73rd and 74th amendments of the Constitution as a result of which finance commissions are required to make recommendations on the measures needed to augment the consolidated fund of the states to supplement the resources of panchayats and municipalities. Even the other issues referred to the commission at the discretion of the President have become more numerous and complex. For example, the Twelfth Finance Commission, like the Eleventh Finance Commission, has been required to make recommendations on the restructuring of the finances of the Union and the state governments. Like earlier commissions, it has also been required to address issues relating to the debt position of the states and the financing of calamity relief. The Twelfth Finance Commission has also been required to review the Fiscal Reform Facility introduced by the central government on the basis of the recommendations of the Eleventh Finance Commission and suggest measures for effective achievement of its objectives. An additional term of reference was also made in regard to sharing of non-tax revenue of the central government from profit petroleum with the states. The expanding scope of the terms of reference and the need to have a mechanism to monitor implementation of the recommendation of the finance commission, place enormous demands on the preparatory and continuing work of the commission that may not have been envisaged by the framers of the Constitution. While we consider updating of data and carrying out of relevant studies on a continuous basis in the interregnum between two finance commissions a minimum essential requirement, some of the additional requirements that have emerged due to the expanding scope of the terms of reference of finance commissions are equally important.

14.6 In our view, bulk of problems faced by successive finance commissions can be overcome by providing for a permanent secretariat for the purpose of doing the preliminary work both in terms of collecting data and organizing research. We, therefore, recommend that the finance commission division should be converted into a full fledged department serving as the permanent secretariat for finance commission. Legally and constitutionally, there is no infirmity in putting such an arrangement in place.

14.7 Another important issue which needs attention is the lack of financial autonomy for finance commissions. All their financial needs have to be cleared by the Ministry of Finance, which acts as the nodal ministry in the government in respect of the finance commission. This results in references, back references, and delays, especially due to finance commission’s work receiving a relatively low priority. The effect of delays in the sanctioning of posts, entrustment of studies, etc., is felt more acutely since the finance commissions are appointed only for a limited time. Another major difficulty experienced by the commission, working to a tight time schedule, has been inadequate delegation in financial matters. For example, the Member-Secretary had only been designated the Head of a Department for exercise of financial powers. Sanctions issued by him were subject to the concurrence of FA (Finance) and Secretary (Expenditure). The need for frequent and repeated references to the Department of Expenditure or Economic Affairs proved to be a great hindrance to the smooth functioning of the Commission. Although the Twelfth Finance Commission was ultimately granted the powers of a government department, it came too late and only towards the end of our tenure, by which time most of our work had already been completed. As such, the declaration could not contribute to the effectiveness of the Commission in any manner. We, therefore, recommend that the secretariat of the finance commission should be vested with the powers of a full-fledged department of the government with Ministry of Finance only as its nodal ministry for the purpose of linkage with the Parliament.

14.8 We also recommend the setting up of a research committee with adequate funding to organize studies relevant to fiscal federalism. The data collected and updated by the secretariat would require careful analysis under expert guidance in a manner relevant to the issues concerning public finance and this process being time consuming, it is suggested that the finance commission should have a tenure of at least three years to do its work adequately. The next finance commission should, therefore, be set up at the beginning of 2007. Further, in order that the commission's time is not wasted in routine administrative matters, appropriate and adequate arrangements for the office and residence of the chairman and members of the commission must be made before the appointment of the commission. This work will be greatly facilitated, if the decision to have a permanent secretariat for the commission is taken quickly and the secretariat is in position much before the Thirteenth Finance Commission is constituted.

14.9 The Finance Commission, as envisaged under the Constitution, is an independent body arbitrating the claims of the centre and the states to shareable taxes. It is, therefore, felt that, as in the case of the Union Public Service Commission and Supreme Court, the expenditure of finance commissions should be treated as expenditure "charged" on the consolidated fund of India, instead of being treated as "voted" expenditure. This will provide a great deal of autonomy to the functioning of the commission.

Monitoring Mechanism

14.10 In our scheme of transfers, we have envisaged a greater role for grants in the overall finance commission transfers, so as to ensure better targeting of expenditure in certain important areas. Our recommendations include specific grants for education and health sectors, for maintenance of roads and buildings, as also for maintenance of forest and for heritage conservation. Grants have also been recommended, within the constraints of available resources, for state-specific needs. We have increased the grants to support local bodies. We have no doubt that the states themselves would be committed to timely and qualitative implementation of the projects / schemes for which we have provided grants, as these have been on the priority list of the states, having been selected out of the demands received from them. That is why, we have specifically mentioned in chapter 10 that no conditionalities, other than what we have prescribed, should be imposed by the central or state governments in respect of release or utilization of the grants. The states must have flexibility in deciding the basket of projects to be undertaken within each sector, in framing the time schedule for various stages of these projects and in reprioritizing within this basket of projects, if necessary.

14.11 To ensure that the end objectives, for which the grants have been recommended, are achieved, it is desirable that the states put a robust monitoring mechanism in place. We suggest that every state should constitute a high level committee for monitoring proper utilization of grants. The committee should be responsible for monitoring both financial and physical targets and for ensuring adherence of the specific conditionalities in respect of each grant, wherever applicable. In the beginning of the year, the committee may approve the projects to be undertaken in each sector, quantify the targets, both in physical and financial terms, and lay down the time period for achieving specific milestones.

14.12 The high level monitoring committee may be headed by the Chief Secretary with the Finance Secretary and the secretaries / heads of departments concerned as members. The committee should meet at least once in every quarter to review the utilization of the grants and to issue directions for mid-course correction, if considered necessary.

Accounting Procedure

14.13 Under the present system of cash based system of accounting, followed by the central and state governments, transactions are recognized, when the cash is paid out or received in. In the books of accounts, expenditures are recorded at the time of payment, i.e. when a cheque is issued, and receipts are recorded when these are reported by the collecting bank. Movements in the government cash balance kept with RBI as a result of such payments and receipts are also simultaneously recorded in the account books. Thus, the government accounts are a record of cash flows into and out of consolidated fund and public account, and the effect of these cash flows reflect on government's liquidity position.

14.14 The cash based system of accounting lays emphasis on transactions vis-à-vis the budget. It does not record and report complete financial information required for management of resources. It does not provide a full picture of the government's financial position at any given point and the changes that take place over time as a result of government policy. The system fails to reflect government's liabilities such as accrued liabilities arising due to unfunded pensions and superannuation benefits and current liabilities arising from a disconnect between commitments and payments. Similarly, the present system is unable to track current assets as well as non-financial assets. It does not provide information on the assets held by the government, much less the cost of holding and operating these assets and the impact of current consumption on the stock of assets. Another major limitation is its inability to record the full cost of providing services by the government's departments or the commitments made by the government regarding payment in future years. The cash based system of accounting provides room for fiscal opportunism, as tax revenues can be collected in excess during a period followed by high incidence of refunds, payments can easily be deferred and passed on to future periods, revenues due in the future could be compromised by providing for one time payments, etc. To quote some other examples, it takes no note of transformation of indebted government agencies into autonomous legal entities outside government through suitable state guarantees, and on the expenditure side, omit existing net liabilities of public enterprises and agencies outside the government, though the latter cannot escape such liabilities.

14.15 Compared to the cash based system, the system of accrual accounting recognizes financial flows at the time economic value is created, transformed, exchanged, transferred or extinguished, whether or not cash is exchanged at that time. It is different from cash based system in that it records flow of resources. Expenses are recorded when the resources (labour, goods and services and capital) are consumed, and income when it is earned, i.e. when the goods are sold or the services rendered. The associated cash flows generally follow the event after some time and may or may not take place during the same accounting period. Thus, in addition to cash flow, unpaid consumptions (payables) and unrealized income (receivables) are also recorded. Resources acquired but not fully consumed during an accounting period are treated as assets (inventory and fixed assets). Payments made for acquisition of inventory are included in the operating cost for the period in which it is consumed. Payments made for acquisition of physical assets, that have future service potential, are amortized over the entire useful life of the asset by charging depreciation.

14.16 The system of accrual accounting, thus, inter alia, allows better cost – price calculations, records capital use properly, distinguishes between current and capital expenditures, presents a complete picture of debt and other liabilities and focuses policy attention on financial position, as shown in the whole balance sheet not just cash flows or debts. It gives a complete measure of cost of various services, takes care of disinvestment receipts and provides adequate information of both fiscal balance and net worth and their changes over time. Information, as would be available under accrual accounts, constitutes an essential input for bodies like finance commissions, not only in assessing the revenue requirements of the centre and states vis-à-vis the available resources, but also in appraising their fiscal performance with a view to assigning due credit to the governments, which have performed well and providing disincentives to those, which fail to measure upto expectations. We understand that some action has been initiated by the central government to move towards accrual basis of accounting. However, the transition would occur in stages, as this is a time consuming process. While we are in favour of a changeover to the accrual based system of accounting in the medium term, we suggest that in the interim, some additional information as mentioned below in the form of statements should be appended to the present system of cash accounting to enable more informed decision making. An illustrative list of statements, which could be included are:

(i) a statement of subsidies given, both explicit and implicit;

(ii) a statement containing expenditure on salaries by various departments/ units;

(iii) detailed information on pensioners and expenditure on government pensions;

(iv) data on committed liabilities in the future;

(v) statement containing information on debt and other liabilities as well as repayment schedule;

(vi) accretion to or erosion in financial assets held by the government including those arising out of changes in the manner of spending by the government;

(vi) implications of major policy decisions taken by the government during the year or new schemes proposed in the budget for future cash flows; and

(vii) statement on maintenance expenditure with segregation of salary and non-salary portions.

14.17 While introducing these statements, the ultimate goal of switching over to the accrual based system of accounting may be kept in view and proformae designed in a manner that facilitates a smooth and effective transition. We have, while dealing with the Fiscal Reform Facility in chapter 11, noted the absence of a standard definition of revenue deficit with states being allowed selectively to include/exclude the deficits of major state government entities like the state electricity board, road transport undertakings etc. for the purpose of measuring performance. We have also noticed that some states have started classifying the grants to local bodies as capital expenditure. Some states are already meeting the deficit of their electricity boards by granting loans or investing in equity rather than providing transparent subsidies. Our scheme of debt relief in respect of repayment of loan during 2005-10 is linked to reduction in revenue deficit so as to eliminate it by 2008-09. It is necessary to guard against any attempts to defeat the objectives of the scheme through creative accounting. We, therefore, recommend that the definition of revenue and fiscal deficits etc. be standardized and instructions for a uniform classification code for all states down to the object head are issued. Unauthorized changes in accounting policies and arbitrary reclassification of expenditure should be viewed seriously by the monitoring agency while granting relief under the scheme.

14.18 The change over to the accrual based system of accounting will place considerable demands on the accounting personnel in various government organizations, particularly at the lower and middle levels of the accounting hierarchy, consisting of accounts clerks, accountants, assistants, treasury officials and others. Although a few of these functionaries would have a formal background in finance and accounts, majority of them may not possess professional qualifications. Even those who have professional qualifications often need to upgrade their skills during their career. In most countries, accountants are required to acquire recognized vocational qualifications in public sector accounting and audit. In the United States of America, for instance, the Association of Government Accountants and Government Financial Officers' Association train accountants to become accounting technicians. Similar arrangements for providing continuing professional education are also in place in the UK, Malaysia, Singapore, South Africa, Behrain, etc. through chartered institutes. The absence of professionalized accounting personnel in the public sector in India has also been commented on by several analysts. Considering the need for qualified and professional accounts staff and training for capacity building particularly in the context of our recommendation for changeover to the accrual based system of accounting, we recommend that a National Institute of Public Financial Accountants be set up by the government of India and its charter be decided in consultation with the C&AG.

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