

# An Analysis on Various Opportunities to Developing Public Sector Financial Management in India

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***Abstract – In recent years the role of a sound PFM system to achieve the objectives of fiscal discipline, strategic planning, and improved service delivery has been getting increasing public attention in India. Since public financial management reforms undertaken intermittently over the years, have not delivered anticipated results in these areas, studies and recommendations of Government appointed committees and expert bodies have identified gaps that need attention to strengthen the PFM institutional framework and to improve the efficiency of government spending. This paper examines key PFM reform measures undertaken in India over the past few years and provides suggestions to enhance the effectiveness of these PFM systems.***

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## INTRODUCTION

Public financial management is absolutely critical to improving the quality of public service outcomes. It affects how funding is used to address national and local priorities, the availability of resources for investment and the cost-effectiveness of public services. Also, it is more than likely that the general public will have greater trust in public sector Organisations if there is strong financial stewardship, accountability and transparency in the use of public funds. It is important for governments to get it right because it impacts on a broad range of areas including:

- Aggregate financial management - fiscal sustainability, resource mobilisation and allocation
- Operational management - performance, value-for-money and budget management
- Governance - transparency and accountability
- Fiduciary risk management - controls, compliance and oversight.

In addition, effective public financial management is important for decision making. Accurate financial information is often used as the mechanism to support decisions and ensure effective resource allocations.

Both the developed and developing countries continue to struggle with the increasing complexities of public financial management and the pace of change. Not least, finance professionals working within the public sector are concerned with improving financial management and budgeting, responding to changes in financial reporting, securing better regulation, strengthening institutions, improving risk management and governance, and eradicating fraud and corruption.

In addition, the spotlight is currently on public financial management as governments across the world increasingly struggle with achieving fiscal sustainability and managing fiscal risk. New and more sophisticated models and tools will be required to help governments deal with fiscal management. Also, there will be more than ever a focus on achieving effective resource allocation, particularly, in resource constrained environments. Governments will have to become smarter to ensure budgets are effectively linked to policy objectives and value for money is secured.

As well as the increasingly complex financial management landscape, the problems of the lack of strong leadership and political support, staff shortages, training and retention, poor reward systems and the lack of a public financial management infrastructure mean that the issues are more

acutely felt in developing countries and emerging economies.

Finding ways to improve delivery of public services, establishing an accountability framework, and proper implementation of pro-poor policies have remained key concerns in India. India's growth rate of more than 9 percent has declined due to the global financial crisis of 2008-09 and fiscal stress has been building up since then. Although there has been steady decline in the poverty level, more than 300 million people remain below the poverty line. The progress in achieving improvements in human development has been slow and India lags behind several other Asian countries (UNDP, Human Development Report, 2007-08). The Government has expanded the scope of the key central programmes, particularly for social sector spending, it is increasingly apparent that in addition to a pertinent set of policies to address these issues, a sound public financial management (PFM) system that emphasizes institutional efficiency is important to design and implement appropriate policies to achieve the desired results.

While the PFM system appears to be consistent with well-established budgeting, accounting, audit, and legislative control systems, recent studies point out that there is still considerable scope to improve the efficiency of government spending and public service delivery by strengthening the institutional framework for PFM. Reform initiatives to make the budget performance oriented, transition to accrual accounting, adopting rule based fiscal management, and strengthening budget management and expenditure control are noteworthy in this context. Still, not all of these efforts have resulted in enduring changes, and increasing demand for better accountability, good governance, and improved service delivery has made it imperative to explore more ways to strengthen India's PFM system. Reform recommendations by Statutory Body like Central Finance Commission and Government appointed Committees like Second Administrative Reform Commission (ARC) and Expert Committee on Expenditure Management in recent years need to be evaluated and implemented to bring in desired changes. The areas in need for reforms as identified by the PEFA report by measuring performance of PFM institutions at the Union level, provides another useful reference for reform initiatives.

This paper examines PFM reform measures that have been adopted over the past few years and proposes ways to enhance the effectiveness of India's PFM system.

Given the complex nature of PFM, this paper addresses fundamental PFM issues discretely and does not purport to provide a comprehensive reform programme. The rest of

the paper is organized as follows. Section 2 deals with various issues related to the budgeting system and Section 3 examines the effectiveness of the delegation of financial powers and the system of financial advisers. Section 4 addresses issues related to transitioning from cash based accounting to accrual accounting. Sections 5 and 6 analyze issues related to internal audit and external audit to enhance accountability. Section 7 outlines concerns with specific intergovernmental transfers and Section 8 notes some institutional changes in PFM that are currently underway and Section 9 contains concluding remarks.

## **PUBLIC FINANCIAL MANAGEMENT AND GOVERNANCE**

The role for public financial management arises at a number of points when considering improvements to governance. Financial management involves the application of doctrines, principles and techniques, but it is wrong to conceive of a financial management reform programme as a technical solution in its own right. Any initiative in which improved techniques are appended to a country's Government without careful consideration of the wider issues of the roles, functions and structures of government and the key priorities that the Government seeks to address is unlikely to promote those objectives.

The public financial management system must be integrated into the total governance framework if it is to contribute as part of an organic whole to enhancing a country's development prospects. There are examples around the world of failures to achieve this integration, which show that it can result in wasted expenditures at best and dysfunctional management systems at worst.

Any particular financial management regime cannot be judged entirely on the basis of whether its various components conform to best practice. Rather, a successful financial management system is a core component of a total system of management and needs to work in harmony with the other elements (human resources, strategic and operational planning, information systems etc.) that are employed to achieve the objectives of government.

For example, the debate about whether accrual accounting should be used or not by Government occasionally misses the point. Accrual accounting is one accounting method that may provide vital managerial data in some circumstances; in others it is an expensive irrelevancy. Accordingly, any decision to adopt accrual accounting methods needs to be based on the particular data needs of public managers and not on purely technical considerations.

Lack of integration between the financial management system and the total management system can make administrative reforms fail or even represent a step backwards. For example, systems of central financial control that prohibit flexibility and innovation in public service provision are common. Similarly, drawing on the modern management philosophy of staff empowerment and granting managers freedom over the use of resources can be a risk in reform programmes in which such freedom is not balanced against those managers' explicit financial accountability.

In comparison with the traditional bureaucratic model of legislated responsibility, performance-based management systems focus on the specification and achievement of explicit goals in an environment of increased accountability.

Such reforms reflect the views of the State that sees its public administration as an instrument for the delivery of economic, social and other goals. Within this rationalist view of the State, the task of the reformer is to find ways to improve the performance of the Government in terms of meeting these goals efficiently and effectively.

Put simply, the principles of effective management involve a clear expression of an agreement about objectives; managers who are accountable for results, the freedom to manage resources subject to incentives for efficiency and effectiveness, and clear information about performance.

While these simple principles of rational management underlie many recent public-sector management reform efforts and have long been established in successful private-sector organizations, it should be remembered that a high standard of organizational performance is ultimately established by people and not management systems. Management systems can increase the probability that people perform successfully but cannot guarantee it; by the same token, poor management systems can inhibit good performances by people who would otherwise be capable of achieving them. The human side of improving performance is fundamental to a holistic approach to improving public management.

## **BUDGETING SYSTEM**

### **Attempts to Make the Budget Performance Oriented -**

Given the complexity of budgeting in the public sector where political choice plays crucial role in decision-making, fulfilling the basic objectives of budgeting functions remains arduous and depends heavily on the effectiveness of institutions to achieve better fiscal outcomes. The Indian approach in this context has been to supplement a line-item budget with a ministry-wise performance budget for

the same budget session. The general budget presented in the Parliament can best be described as traditional budget and displays characteristic problems. This system allows substantial adjustments in the budget during the year indicating the absence of a hard budget constraint, particularly since departments surrender substantial amount of unspent money under various programmes at the lapse of the financial year<sup>3</sup>. Unspent provisions are indicative of lack of efficiency in programme management at departmental level in a strict annual budget cycle. Revenue projection has always remained a challenge as the movement of economy and changes in tax administration determine the actual revenue collection.

Since the traditional budget does not provide information on results to be achieved from the use of public resources, one needs to look at the performance budgets of the ministries and departments. The performance budget in India was introduced in 1968 following the recommendations of the first Administrative Reform Commission. The objective of introducing the performance budget as a supplement to the traditional budget was to provide a link between the financial budget of the departments to tangible targets in order to enhance the effectiveness and efficiency of public spending. In addition to lack of adequate preparation and capacity development, major impediment experienced while preparing the performance budget was the absence of realistic performance measurement in terms of developing performance indicators for schemes and projects run by the departments. Over the year it evolved as translation of departmental budgets by incorporating the general physical expectations from the plan schemes run by them. The preparation of performance budget had become a routine affair like compilation of another document without any discernible influence on resource allocation linked with results. The weakness of the performance budget as practiced over the years became more apparent when the Government decided to adopt another version of performance budget called the Outcome Budget in 2005.

### **Medium Term Perspective in Expenditure Planning -**

Medium-term expenditure planning provides a perspective of projects spreading over a number of years and adjusts expenditure priorities. In India it was maintained that five year plans provide the basis for a multi-year perspective for resource allocation. The feature of breaking up the medium term five year plans into annual plans and integrating them annual budgets and further monitoring of their progress was an important innovation. The development planning-budgeting link in India, however, has not been smooth. While plans provide conceptual framework by focusing on various sectors in the economy, the budget is more concerned with systems of control over the use of funds by government and pay more attention to financial aspects. In

the current budgetary practice, the link between the plan and the budget is tenuous. Planned goals, objectives, outputs, and resources allocated to achieve them are not adequately integrated into the annual budgets. The basic feature of plan allocation through schemes and sectors does not remain the same when the budget is prepared under different heads and sub-heads following the existing budgeting classification. It is therefore, difficult to link the plan objectives of various schemes/projects to budgetary practice of allocating resources under various heads. It takes considerable effort to link objectives of the various schemes/projects to the expenditures under various heads and sub-heads.

**Fiscal Rules and Budget Management-** The Fiscal Responsibility and Budget Management Act (FRBM) was adopted in 2003<sup>12</sup> in response to severe deterioration of public finance both at Central and State levels in late nineties and failure to salvage the situation through discretionary policy actions. The combined (both Centre and States taken together) fiscal deficit crossed 9 per cent of GDP and debt-GDP ratio grew considerably with slowing down of the economy during early part of 2000s. The FRBM act was adopted with the objective to reduce fiscal deficit to GDP ratio at 3 per cent both by Central and State Governments by 2008-09 and to balance the current account, and to maintain long-run fiscal sustainability and prevent an increase in future indebtedness.

## A FRAMEWORK FOR BETTER FINANCIAL MANAGEMENT

A number of models have been developed for helping organizations to improve and assess how well their public financial management functions are performing. We have outlined three models and diagnostics which can assist in improving public financial management. There are many more, but in our view these are perhaps the most helpful and have had proven results.

**The Audit Commission model-** This model, developed by the Audit Commission in England, uses the metaphor of a journey, in which one starts at one place and wants to arrive at another. The model identifies five key improvement phases: taking stock, getting started, setting strategic direction, making it happen and keeping on track. This allows one to gain a better understanding of how organizations have improved public financial management over time.

As reflected in the case studies and this model, public sector organizations seeking to improve financial management share some similar characteristics. Quite simply put, there are four elements that have been applied

to organizations that have successfully improved public financial management. These are:

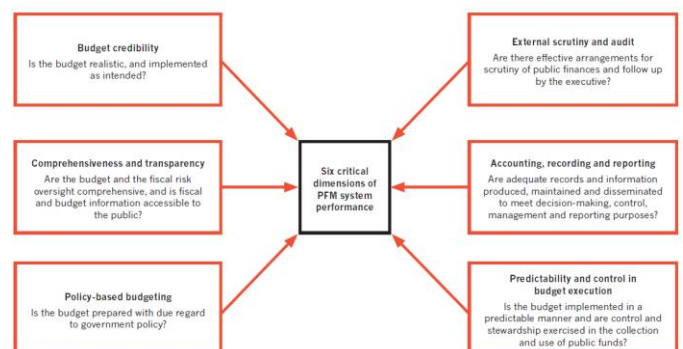
- Clarity of purpose and strategic direction
- Effective political and managerial leadership
- The basic building blocks for achieving change
- Driving and sustaining change.

Public sector organizations can measure their progress against these four elements when embarking on a change programme, as outlined in a slightly adapted version of the Audit Commission's model.

This model is helpful for public sector organizations in assessing whether they are at an early stage on their improvement journey or have made significant progress. It is not the only model for improving public financial management, but arguably it is one of the most effective. The model can be used to complement those instruments for measuring success that donor institutions, governments, national institutes and regulators already use. It is particularly useful for taking a strategic overview, prioritizing and ensuring that the focus is clearly on the issues that need to be addressed.

**Public financial management measurement framework model-** A second model is the public financial management (PFM) measurement framework developed by the Public Expenditure and Financial Accountability secretariat (PEFA), the World Bank and IMF. This performance measurement framework is mainly focused on governments, but can be applied to other parts of the public sector. The model sets out high level performance indicators which can be used to assess performance.

There are six critical dimensions to the model as set out below.



The advantages of using this model to assess performance on improving public financial management are that it:



- Enables an integrated assessment of performance of PFM systems
- Demonstrates progress in PFM performance over time
- Enables regular, rigorous, evidence-based monitoring by domestic and international stakeholders
- Provides a common information pool on PFM performance.

### **ROLE OF INTEGRATED FINANCIAL ADVISORS IN FINANCIAL MANAGEMENT**

Through delegation of financial powers from the Ministry of Finance to agencies, the departments enjoy considerable freedom to spend their own budget allocations and maintain the accounts. To support the departments to exercise the enhanced powers delegated to them, a system of Integrated Financial Advisors (FA) was developed. This institutional form has assumed crucial role in developing financial management capability of departments spanning over policy formulation and implementation to functional oversight on accounting and budgeting aspects. While assisting the departments in achieving their goals and ensuring value for money, the FAs also act as representatives of the Ministry of Finance in all financial matters. Indeed balancing the dual role, advising the Secretaries of the departments and acting as 'eyes and ears' of the Ministry of Finance is a difficult job for the FAs.

The role, authority, as well as accountability of the Financial Advisers were revised through a charter in 2006 to enhance their capacity to meet the challenges associated with this role<sup>14</sup>. Redefining the charter, as the official memorandum indicates, was intended to assist the departments in achieving their objectives, facilitating implementation of the approved programmes with due financial prudence, ensuring the monies allocated were spent on time and in prescribed manner, and ultimately ensuring 'value for money'. The responsibilities assigned to the FAs through this revised charter have been ambitious since they include most of the financial activities starting from performance budgeting (outcome budget), expenditure control and cash management, to project formulation and appraisal and monitoring and evaluation functions. The revised charter has raised many questions regarding the expectations from FAs since the expansion of responsibilities does not match with existing powers and support systems. Since the effectiveness of the role of Financial Advisors is circumscribed by the management framework within which they function, addressing these

concerns exclusively with FAs would not be too helpful. Rather, capacity building and support from the administrative ministry would be more helpful. In India, there is no separate cadre of Financial Advisers, and it should be recognized that financial management in the public sector can no longer be treated as a function of generalist officers. The lack of attention to the technical and professional skills of FAs compares unfavorably with the heavy and technical nature of responsibilities required of them.

### **GOVERNANCE ISSUES AND PUBLIC FINANCIAL MANAGEMENT**

Linking financial management with the wider issues of public management and development involves consideration of the political mandate and role of government, the processes by which its authority is exercised and its capacity for formulating and implementing policies. Collectively, those facets of government interaction with the civil society are referred to as governance issues.

The aide-mémoire for the resumed special session of the General Assembly on public administration and development focuses on the need for intellectual infrastructure, both human and institutional, to move from crisis management in the public sector towards an enabling environment conducive to development. The aide-mémoire notes that significant responsibility for the creation of a competitive, dynamic and resilient economy rests with the public service.

Indeed, it is agreed that the current widespread determination to improve governance structures and processes in the public sector is affecting rapid shifts in the scope and machinery of government. Within the context of reorienting government, the relationship between governance capacity and successful public administration reforms, particularly in the least developed countries and countries with economies in transition, must be examined.

There is evidence from around the world that poor governance undermines the prospects for improved prosperity in developing and industrialized countries alike. While it is an obvious point that a government's effectiveness is determined by what it chooses to do and how well it manages the implementation, it is observable in many countries that the Government assumes an expansive development role while failing to deliver reasonable levels of basic public services.

Governance structures and processes have a determining effect on the formation of national development objectives, the effectiveness of policy design and implementation

efforts aimed at achieving them, the quality and availability of public services, the effectiveness and efficiency with which they are delivered, and even the legitimacy of the whole apparatus of government. The concept of governance spans this whole range of issues and provides a useful basis for reconsidering the scope and conduct of government. The World Bank, in its role as a multilateral funding agency, has identified three key aspects of governance: the form of political regime, the process by which authority is exercised in the management of the country's economic and social resources for development, and the capacity of Governments to design, formulate and implement policies and discharge functions.

Since the first aspect of governance is outside its mandate, the World Bank focuses its attention on the remaining two and reports on its governance activities under the following major headings, which are relevant to United Nations deliberations on this subject: public-sector management; accountability; legal framework for development; and transparency and information.

## **INTERGOVERNMENTAL TRANSFERS AND PFM CONCERNS**

The Intergovernmental resource transfer system in India continues to be complex, which involves several conduits like the Finance Commission, Planning Commission and several Central Ministries. In addition to devolution of central taxes determined by the Central Finance Commission and plan assistance determined by the Planning Commission of India, Centrally Sponsored Schemes (CSS) have emerged as a key source of funds in social and economic sectors for States. These are specifically designed programmes for employment generation, primary education, basic health services and rural infrastructure and run by the concerned central ministries. The CSS form part of the Central Plan as they are meant to provide additional resources to the states for implementing programmes that are considered by the Government of India to be of national/regional importance. Over the years the CSS has become an important tool of the central Government to influence policies and expenditures on subjects constitutionally allocated to the States. The funds under these programmes are provided in respective budgets of Central Government Ministries, implemented at state level by specifically created implementing agencies and rural local bodies. The budgetary provision for direct transfers to implementing agencies has increased from Rs.1890 billion in 2010-11 to Rs.1246 billion in 2011-12. The PFM concerns are many in this type of funding through central programmes. The funding of the big ticket CSS bypass the state budgets and are routed through implementing agencies such as missions or autonomous societies created under the

provision of the specific schemes, and local bodies. A direct transfer of resources to state budgets would seem to have merit in terms of accountability. However, apprehensions regarding timely release of central funds by the States to the designated central programmes led to creation of implementing agencies in States and directly routing funds to their bank accounts outside state budgets. This funding arrangement is considered efficient so far as fund utilization is concerned in a timely manner. Although state functionaries predominantly man these agencies, the financial management of the implementing agencies remains outside the formal accountability structure of both the central and state governments. Mere release of funds to the agencies at central level is considered as expenditures, which is not reflected in the state budgets. A certain level of utilization in the form of an unaudited certificate is needed for the next level of funding. Rather than the CAG, the empanelled chartered accounts audit such bodies. The information on availability funds and actual expenditure by the service delivery units, a school or a health service unit, at the far flung areas is sketchy. Given the diversity in the implementation hierarchy, the number of implementing units and the geographical reach of central schemes, it has remained a challenge to have meaningful information on these schemes and support informed planning. Further many a times these programmes are caught in political tangle as regards their ownership and accountability in delivering services.

## **CONCLUSION**

Financial management was dominated by central controls that were excessively process-oriented. Effective communication between the central and the spending agencies about resource realities was lacking. Centralization, while contributing to an avoidable abuse of power and trivializing controls, imposed an additional strain on the process and on policy makers. More important, it contributed to a loss of financial consciousness in the spending agencies. As the types and instruments of control increased, efforts to control waste and abuse of authority became diffuse and lacked accountability.

While the reform initiatives undertaken to strengthen PFM institutions over the years in India have yet to meet their full potential, they underline the intent of the Government to boost the efficiency and effectiveness of the system. There are gaps and unfinished agenda that need further action and refinement. These include producing suitable performance measures that will influence budgetary decisions; continuing with existing efforts to expand accrual accounting, modernizing internal audit and control, improving the effectiveness of external audit, and introducing an exclusive procurement law. In contrast to the intermittent nature of past efforts, the future agenda

should focus on continuously evaluating the outcome of these changes in order to take corrective action as soon as possible. At the same time, expectations of immediate results from these reforms may be misplaced. There is always a time lag for institutions to deliver expected results. In a large country like India where the fiscal federal nature of the country puts large functional responsibility on sub-national Governments, a coordinated approach is needed to focusing the ability of the PFM system in delivering quality services at the State level. The capacity and willingness to internalize and change at State level, and political involvement and willingness to steer the changes are also key to facilitate the reforms.

It is hoped that this paper has given an insight into the scale and complexities of public financial management issues that often need to be addressed in developing countries and emerging economies. More importantly, it has shown how some issues have been successfully overcome and the lessons learnt and it provides useful guidance for helping organizations to improve public financial management.

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