The Railway Budget: What It Will Contain and What It Should Contain

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In an effort both to fund the investment programme of the Indian Railways as well as to create the mirage that the current leadership has managed to do it without recourse to raising fares or imposing visible economies, the railway budget has been transformed over the years into a tool for presenting unreal figures. In the process, presenting the success of the railways as a reflection of the policies of a political party in power or even of the personality of the railway minister has become a routine in which everybody plays a willing part. The party in power, the railway minister, and the officials of the ministry then find little option, in lean years, but to continue the window-dressing, the half truths and sham accounting.

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The railway budget for 2011-12 is due to be presented in two weeks and there is discussion and debate on what it will hold. But the debate may be different this time because the last few years were grand successes, while this budget follows a year of performance below even modest expectations. This article reviews the nature of railway finances, the compulsions and where we stand with respect to the budget for 2011-12.

The budget exercise has traditionally consisted of first tabulating the previous year's accounts, extrapolating the numbers for the next year and then making changes in rates and fares to suit plans or needs of the coming year. More specifically, once the earnings arising from the actual level of passenger and goods traffic in the previous year were reasonably estimated and so too the costs of operations, marginal increases could be applied to the traffic and costs levels to arrive at expected earnings and expenditure, and hence the surplus in the next year. In the meantime, the "works programme" or the plan of investments was also prepared and after considering the expected contribution from the central government (budgetary support) and the reserves available, the surplus required in the coming year was assessed.

For many years, the need has been urgent to provide adequately for replacements and improvements and railway ministers have raised rates and fares to make ends meet. There is a tradition of the "required surplus" exercise, once completed, being carried personally by the financial commissioner to the railway minister, with three formulae, combinations of fare or rate increases that could balance the accounts, with a cushion for reduction after the protest and anguish of rail users. One of the formulae, or something in between, would be chosen and released to the budget directorate, for casting overnight the final figures and presenting them to Parliament on the morrow.

For the past few years, in contrast, the railways have been "doing well" and it has been possible to manage without the more visible hike in passenger fares. In fact, the previous railway minister presented the railways as some kind of management miracle, a view cheered and proclaimed by management institutes and the press. In the current year, when the picture is not so rosy, the management institutes are silent and the press is calling for raising fares and reducing spending by the rail minister in her home state.

Nature of Railway Finance

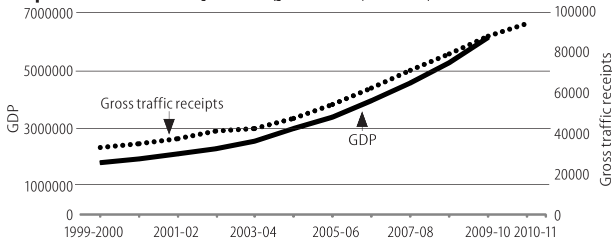
While there is no doubt that levels of fares and costs of inputs immediately affect the surplus of the railways, a closer look reveals that the factor that crucially affects the surplus of the railways is the level of traffic. With most of railway custom being captive traffic, the fare levels undoubtedly affect revenues, but they would have a negligible effect on traffic levels. Let us look at the assertion that it is the level of traffic that affects the surplus the most.

The nature of costs in the railways is that there is a large element of fixed costs, which do not change substantially with rising or falling traffic and only a small element of variable costs, or costs that change directly when traffic changes. The largest fixed cost of the railways is the staff cost. There is some small increase in the allowances of running staff if more trains are run, but as the number of staff is the same, the wage bill is largely fixed. The only major item that changes with traffic is the cost of fuel, and this change is not proportionate, but partly marginal.

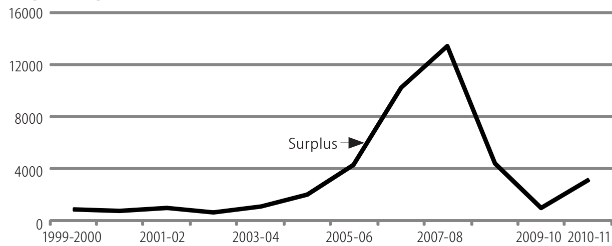
Table 1: Earnings, Surpluses and Composition of Earnings and Expenditure

Year	Earnings	Surpluses	Goods	Passenger	Fuel	Wages, Pensions, Stores and Miscellaneous
	in Rs '000 Crore		as % of Total Earnings		as % of Total Expenditure	
2004-05	47.4	2.07	63	29	19	81
2005-06	54.4	4.34	64	29	25	75
2006-07	67.7	10.2	65	26	25	75
2007-08	71.7	13.4	65	27	26	74
2008-09	79.9	4.46	66	27	22	78

Graph 1: Growth of Railways' Earnings and GDP (in Rs crore)



Graph 2: Surpluses (Rs crore)



The result is that if the system is running for some years with revenue matching expenditure, a rise in traffic would affect only a small percentage of the cost. But the revenue would increase to the full extent of the rise in traffic and there would be a leap in the surplus. On the other hand, a small dip in traffic would hardly bring down costs, but would reduce earnings to the full extent, leading to a sharp contraction in the surplus.

Table 1 (p 26) shows how the mix of freight and passenger components of earnings has been steady over some years and gives the composition of the major fixed and variable costs.

We can see that as earnings have risen, the distribution between goods and passenger services have remained almost the same. But under expenditure, the component of the fixed element, viz, wages, pension, stores (largely a fixed cost) and "miscellaneous", has fallen (except in 2008-09, when there was the impact of implementation of the Fifth Pay Commission), while the share in total costs of fuel (the major variable component), although rising, has stayed low. As a result, while earnings have risen, the surplus has risen much more steeply (except in 2008-09, as stated, because of the impact of the Pay Commission).

This is typical behaviour of high fixed cost industries, and the operating ratio, or the fraction of costs to earnings, on which the railway ministry (and financial dailies) place great reliance, is not an appropriate indicator of efficiency of operation. No doubt it is an indicator of how much one has earned more than spent. But because earnings and expenditure change disproportionately with changes in levels of operation, watching the ratio alone is misleading, as were recent conclusions that an aggressive method of working had helped the railways "turn the corner" and come "out of the woods"! Apart from a small element, granted, of the railways earning more by charging the Box wagon for greater weight, the larger surplus of the Indian Railways in recent years (apart from the window-dressing in 2007-09) has come mainly from higher traffic levels which are directly connected to the greater economic activity all round.

Graphs 1 and 2 show the steady rise in earnings and surplus, except for a dip of the latter during 2007-09, which was largely because of the net railway expenditure rising by the impact of the Pay Commission (arrears payment). As can be seen this rise parallels that of the rise in India's GDP.

The White Paper, Etc

Some years ago, before the Indian economy started growing rapidly, railway surpluses were hard to come by and it was difficult to find funds to catch up on overdue replacements. The thinking then trained its guns on "falling budgetary support" and came out with studies of how the railways, constrained to borrow from the Indian Railway Finance Corporation for increasing rolling stock, was falling into a "debt trap", with fresh borrowings only good enough to service existing debt. The railways then looked for more support from the central government but also tried to find "modern" ways to meet the gap, with privatisation and public-private partnership, for instance.

Somewhere, it was forgotten that railway finances have evolved over a century, with the objective of economic development and charging as "the traffic can bear". The railway industry, the world over, does not work beyond its break-even point and has been largely state managed. The entry of the private sector advisers and the jargon of the management gurus introduced new ideas of a quick fix "turn-around", like setting right the working of an ailing business, or even a private sector bank, which have different priorities. That the railways' management is largely trained not in accountancy but in the routine, although elaborate method of compiling accounts,

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and also stands in awe of the modern consultant breed did not help matters.

A subject of concern had been the funding of replacements, which is done in the railways from an account called the "Depreciation Reserve Fund" (DRF). This fund consists of a charge on surplus, to be employed in programmed replacements, mainly of track and rolling stock. The demand, or level of replacements required, is developed from the field, through analysis by field executives of the age and condition of assets in their charge, and one purpose of the annual budget exercise has been to generate funds for replacements. Special committees go into the details and have periodically raised the alarm when replacements are falling behind and corrective steps are then taken. Because of the vast spread of the railways, the annual requirement is quite steady and there is no need, for instance, to create a "sinking fund", which would have the same utility.

The main thing is that despite the name, DRF, this head of account has little to do with the concept of depreciation in accountancy. In accountancy, depreciation is a cost that has already been incurred, due to wear and tear of assets, and it is not correct to declare profits without first reducing this value, which has been lost. When deducted from profits, this amount can either be used for return to the owners, as refund of capital, or it can be reinvested. But the value of depreciation for private business is that it is subtracted from profit and less income tax is paid.

In such cases, depreciation has to be carefully worked out, based on the actual inventory of assets and auditors and income tax inspectors take pains to see that more depreciation is not charged than due. In the case of the railways, on the other hand, we are not calculating a profit for distribution of a dividend (although there is interest on the capital invested by the central government which is known by that name) nor is there a question of payment of income tax. On the other hand, there is a functioning system of local units, which maintain the assets distributed all over the country and which have arisen at different times at often unknown costs, reviewing the condition of the assets, and local administrations (the Railway Zones), proposing replacements in an organised way. But private sector critics jumped on the fact that "depreciation" was not being worked out as it was done in their own domain and at one stage the railways had to commit in Parliament that they would prepare an "asset register", for accurate estimation of depreciation.

Some completely imaginary guesstimates of original asset value, many ridiculously off the mark, were compiled and forwarded to the Railway Board to satisfy the hapless official who was dealing with the subject. That the exercise is futile and worthless is still lost on many who think it can and should be done.

The Works Programme

The objective of the budget exercise is not just finding revenue to cover operating costs but to also generate a surplus for replacements, improvements and additions,

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Table 2: Annual Outlay, Components and Funding by the Surplus (in Rs Crore)

Year	Total Outlay	Outlay			Provision for Replacements	Surplus
		Capital Assets	Planned Replacements	Remaining Outlay		
(1)	(2)	(3)	(4)	(5)	(6)	(7)
2005-06	15,132	7,185	3,026	4.921	3,775	6,193
2006-07	20,977	7,858	4,239	8,878	4,198	10,206
2007-08	26,573	8,121	6,350	12,102	5,450	13,431
2008-09	29,583	9,326	8,033	12,224	7,000	4,459
2009-10 (RE)	30,485	15,861	9,522	5,102	4,500	951
2010-11 (BE)	32,306	15,875	7,600	8,831	7,600	3,173

Table 3: Budget and Actual Levels of Earnings/Expenditure in 2010-11
(Up to December 2010)

Item	Budget Estimate (Rs Crore)	Expenditure till December 2010 (Rs Crore)	Budget Pro-rata till December 2010 (Rs Crore)	Percentage of Budget Estimate		(Shortfall)/ Excess over Budget (Rs Crore)
				Actual	Budget	
Earnings	94,765	66,982	68,089	70.3	72	(1,107)
Ordinary working expenses	65,000	52,148	48,571	80.2	77.5	3,778
Investment	31,275	23,450		75	77 (last year's %)	

apart from meeting the liability of the dividend, or interest on capital invested by the central government. New lines, doubling of lines, the improvement in gauge conversion, additional rolling stock and new office or residential buildings are funded by capital, which is contributed by the central government. But the areas of renewal of the track and bridges and replacement of over-aged and unserviceable assets, improvements, passenger amenities and traffic facilities need to be funded out of the surplus.

The position of funding in recent years is briefly shown in Table 2. Out of the portion remaining after deducting the outlay on capital assets (col 3), which is contributed by the central government, funds for planned replacements (col 4) are specifically provided for from revenue (col 6) before computing the surplus (col 7) that is to cover the remaining outlay.

It can be seen that until 2008-09, the figure of provision for replacements (col 6) is of the same order as replacements planned (col 4), and the surplus (col 7) has been adequate to meet the remaining outlay (col 5).

In 2009-10, with traffic not growing as projected and the impact of the pay commission, a small provision was made for replacements and the budgeted surplus was negligible. The matter was managed by regulating the actual costs of replacements or other outlays and also drawing on the balance of the funds, out of allocation from the previous years' surplus for activities like replacements, passenger and traffic facilities, etc. When the actual accounts were finalised, the fund balances were all but wiped out and the surplus was just Rs 7.5 lakh. What the showing would be in the current year would thus be a starting point to consider how vigorous the next year's investment plan can be.

A serious criticism of the railway's works programme is that while there is a substantial outlay each year for ongoing and new projects, there is a shelf, many times larger, of work that has been started and expenditure incurred, but that has been languishing, for want of funding and, soon, a disappearance of the will or sponsors to see it through. Thus, even if the department were to declare a moratorium on new projects, the existing commitments would call for a funding programme of the same scale. There may hence be little option to providing a certain minimum investment programme.

Performance in 2010-11

The outcome in 2010-11 was not expected to be like 2006-07 or 2007-08, when the surplus was in five figures. The growth of earnings was expected to be sluggish, but was still pegged at Rs 6,400 crore more than the level reached after increases of Rs 8,500 and Rs 8,100 crore in the previous years. Expenditure, also, despite there being none of the Pay Commission arrears liability of the previous two years, was expected to rise, but the increase was limited to a level that many considered unrealistic. And in this manner, a Rs 32,000 crore investment plan was approved by Parliament.

The performance, so far (end December) is, however, well below what is required and is a matter of disquiet (Table 3).

We can see that there is a net shortfall of Rs 4,885 crore, which wipes out even the planned surplus. The shortfall, in fact, is even more, as the "budget proportions" appear to have pushed the earnings to the end of the year. There is a six million tonne shortfall in loading of goods in the first 10 months of the financial year and this is almost sure to grow by 31 March.

On the expenditure side, despite the Rs 3,778 crore excess so far, a provision for DRF and pension need to be made. The budget for these in 2010-11 was Rs 7,600 crore and Rs 14,500 crore, respectively. With a shortfall in the surplus, the alternative being pursued is to slow down replacements, but there may be no recourse in regard to pension liabilities because these are inevitable costs. The liabilities, in fact, are showing indications of being well above budget levels.

Year after year, the solution to a funds shortage has been to "hold up payments", usually resorted to in the month of March or even February, to postpone expenditure to the next year. This had been vigorously practised in 2009-10, and 2010-11 got off to a bad start. But things became bad very early in the current year and measures to "hold up" were started in some units even in July 2010! For all that, we see that the "works" expenditure is at a healthy 75%, just marginally below last year's level of 77%, which is really not significant, because last year's outlay was 6% smaller. With no respite through better earnings, it looks very much like the railways may need to seek assistance from the general exchequer to close the books at the end of the year. This without saying anything about the dividend liability of not less than Rs 6,000 crore, which also has to be met from the surplus!

Next Year's Prospects

As was stated earlier, the method to develop the budget is to first estimate the earnings and expenditure at current rates. A systematic assessment of goods traffic prospects is unlikely to result in projections of any substantial increase. But it is

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important that the exercise be realistic and targets vigorously pursued. An important aspect of realism in this context is that it is the general economy that needs to make rail traffic available. On the passenger side, there has been a call for increasing fares, which is eminently justified and also good for increases in the region of Rs 1,000 to 2,000 crore. But this will certainly be resisted, as in the past.

With the commitment of the railways to fund large investment programme, the budget targets in earnings are sure to be set high, the flight of imagination in proposing traffic levels having to be tempered by the will to raise fares, surcharges and freight rates. Even for 2010-11, the revised estimates are likely to show a sudden growth in earnings in the last quarter, if only to present a healthier picture for the annual budget!

The test of the budget for the coming year would lie in planning an economy of expenditure. Postponement of essential work and payments in the current year will have an impact on the availability of free funds in the coming year. Replacements and track renewals cannot be delayed indefinitely. Apart from affecting the working of the railways, this affects the demand for steel and manufacturers of track fittings and sleepers. Wages and staff costs are rapidly rising and this would call for pushing very hard at generation of earnings to make ends meet.

The works programme needs to be contained, old and useless work weeded out and limits on sanction of new work strictly enforced. The railways have one of the world's most evolved systems of monitoring the cost and progress of projects – we do need to get down to business. The only tool the railway management has to achieve all this is the railway budget, and this has to be set free.

A Better Way

Mid-February is really no time to propose a better way, because budget changes take months if not years to bring about. But any time is a good time to start looking at the railways as a national asset that it is in everybody's interest to support. The railways have benefited, in expansion of assets and capacity, from the recent years of economic progress. The railways carry more passengers with greater comfort, more goods with powerful locomotives and a larger wagon fleet, unigauge has been ushered in (a unique exercise in the world), tracks have been upgraded and electrification has progressed.

The progress has come about because the railways are basically a sound business undertaking, which national progress can afford. The railway budget, in its pure form, is an accounting statement of how efficiently the current year was managed with reference to a plan, followed by a plan to regulate the working of the next year. The plan can be made accurately, considering all the objectives and resources, and the review can be analytical holding out for lessons for the future.

In an effort both to fund the investment programme as well as to create the mirage that the current leadership has managed to do it without recourse to raising fares or imposing visible economies, over the years the budget has been transformed into a tool to present unreal figures. In the process, presenting the success of the railways as a reflection of the policies of a political party in power or even of the personality of the railway minister has become a routine in which everybody plays a willing part. The party in power, the railway minister, and the officials of the ministry then find little option, in lean years, but to continue the window-dressing, the half truths and sham accounting. It is all part of a vicious cycle.

The investment programme obviously must go on. Replacements are unavoidable and there has to be growth, both for national development as well as health of the railways. To review sanctioned, but ineffective projects, in order to shrink the fat in the programme, is a difficult task and can only be achieved through a drive sustained for many years.

For all that, there can be no change if political will is not exercised to allow the budget, once and for all, to tell the numbers as they are. The government, as a whole, has to understand the limitations of the railways, as a tool for development, to fund fully and always its own growth programme. In lean years, there has to be flexible funding for the railways from all sources and the railways need to be viewed as a continuing national venture, a responsibility of the party in power, not its racehorse, to flog and then to parade!

The railway bureaucracy cannot bring this change about by themselves. But political will can be moulded by public opinion. The press and media need to go beyond filling pages with the numbers and the budget speech on 25 February. They need to keep watch till the end of May, when the actual figures of 31 March are ready, and continue the debate.

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