Economic and Functional Classification of a Budget

What is budget classification? - Its importance:

Budget classification is one of the fundamental building blocks of a sound budget management system, as it determines the manner in which the budget is recorded, presented and reported. According to the IMF Fiscal Affairs Department, *"A budget classification system provides a normative framework for both policy decision making and accountability. Classifying expenditures and revenues correctly is important for (1) policy formulation and performance analysis; (2) allocating resources efficiently among sectors; (3) ensuring compliance with the budgetary resources approved by the legislature; and (4) day-to-day administration of the budget."*

A system of budget classification should contain a classification of revenues into various categories (including an **'economic'** category), and **administrative**, **economic**, and **functional** classifications of expenditures.

- The **administrative** classification identifies the Body or the Department that is responsible for managing the public funds concerned, such as the Department of Education or Department of Technology.
- The **economic classification** identifies the type of expenditure incurred, for example, salaries, goods and services, transfers and interest payments, or capital spending.
- The **functional classification** categorizes expenditure according to the purposes and objectives for which they are intended, for example, education, social security, housing etc. This is very important for the purpose of **policy formulation and allocative efficiency.**

More on economic and functional classifications: The **economic classification** may be used in respect of both revenue and expenditure. For example, it may indicate whether some particular government receipts have been derived from tax revenues or from the sale of goods or services. On the expenditure side, it may indicate whether the outgo was on salaries or interest payments.

As noted earlier, a **functional classification** organizes government activities according to their broad objectives or purposes. It is independent of the government's administrative or organizational structure. Such a classification is especially useful in analyzing the allocation of resources among sectors. It may also be used for tracking poverty-reducing expenditures. Also, it is widely used to compare the changing pattern of government expenditure or policies over the years. The Classification of the Functions of Government (COFOG) established by the United Nations is considered to be the international standard in this field.

The IMF's *Government Finance Statistics Manual* (*GFSM 2001*) provides a standard framework for developing a new budget classification structure or improving an existing one. We give below some examples of items under the "economic" classification (expenditure side only) as well as under the "functional" classification to give a clear idea about the differences between the two. It may be noted that the table below does not compare the first item in column (1) with the first item in column (2) or the second item in column (1) with the second item in column (2), as is frequently done in comparative tables. This is not possible here as the two classes have different goals, purpose and design.

Economic classification	Functional classification
1. Compensation of employees 2. Use of goods or services 3. Consumption of fixed capital 4. Interest 5. Subsidies 6. Grants 7. Others	1. General public services 2. Defence 3. Public order and safety (includes expense on judiciary) 4. Economic affairs 5. Health 6. Education 7. Social Protection (including old age pension, unemployment benefits, disability grants etc)

As clear from the above table, functional classifications focus on the pattern of resource allocation, while economic classifications basically focus on different heads of revenue expenditure.