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**Article**

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## **Public Budgets: New Challenges**

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**Abstract:** Budgeting is passing through changes all over the world in order to find more efficient ways to guide public money usage. The last half of century gave us multiple examples of how to improve budgetary performance, but there are a lot to do in next decades to accomplish this goal. The challenges regarding public budgeting are: using accrual based budgeting, use performance information to determine the allocations for each agency, and strengthening the budgetary transparency.

**JEL Classification: H61**

## **1. Introduction**

The main financial document that reflects the state policy regarding the set up and the use of public resources is the budget. The budget is an instrument that constantly adjusts to the new economic realities. The history of the last decades has proved that the periods of economic crisis from a certain country or region have led to further concerns regarding the improvement of public money management through public budgets. The 1980s have been returned to improve budget management, especially due to economic recessions and crises. The first states that implemented budgetary reforms as measures to diminish the effects of these phenomena have been New Zealand, Denmark and South Korea. Meanwhile, the budget based on performance has spread rapidly to most states, but each one chose their own method, best suited to their economies.

The solution found for increasing the efficiency of the use of public funds consists in using performance

indicators in the budgetary process. This idea isn't new, since it has also been recommended by the Hoover Commission in 1947. Switching to performance-based budgeting is done slowly, and in a close correlation with the financial, human and technical resources that are available.

At the present, there are some trends that follow the increase of efficiency of activities through a better adaptation of budgets to the new economic requirements. The solutions offered by theorists and practitioners, that haven't been applied up to now, can be grouped and analyzed as challenges that must be involved by the future budgets. The aim of this study is to present the main challenges that we have identified and grouped as follows:

- Migration towards accrual based budgets;
- Developing the budgetary performance indicators;
- Strengthening the budgetary transparency.

The use of resources must be correlated with the level of income as well. The authorization of expenditures is done in correlation with the revenue

estimations. Thus, not receiving the projected revenues can lead to severe disequilibria. In the specialized literature, the term „fiscal space” can be found, which deals with the way in which decisions are taken with regard to the financing of public activities, taking into account the gap between projected revenues and expenditures (Schick, 2008 and Heller, 2005).

The budgetary sustainability must be ensured on the medium and long term, since a part of the actual budgetary revenues (especially in the part of social security contributions) are collected for supplying services and rights in the future decades.

## **2. Migration towards accrual based budgets**

A clearer image of the economic realities from the public sector can be obtained with the help of some economic indicators that reflect the exact state of the patrimonial situation and of the financial flows that result from the financial accounting of each public agency.

Their predicted modification is done with the help of budgets. While the financial statements are, in most cases, accrual-based, the budgets are, most of the times, cash-based (despite this, there have been timid movements towards the use of accrual based budgets).

Sticking to the budgetary issues, from the above mentioned, we can conclude that two types of budgets exist even that are closely correlated:

- cash based budgets;
- accrual based budgets.

Cash based budgets are the most frequently used, since they correspond to the classical method of budgeting. Accrual based budgets have been implemented in only a few states, the most important being Australia, Denmark, New Zealand and Great Britain (Robinson, 2009). The difference between the results of the two approaches is not major, but the basic principles are different. In practice, accrual based budgeting can be implemented only if the budgetary process is properly adapted, which means that there has to be transparency in the use of funds and a managerial freedom at the public institutions' level (Schick, 2007).

Accruals help make a better evaluation of the performances that were obtained through the implemented projects, due to the identification of their full costs (Diamond, 2002).

## **2.1 Cash Based Budgeting**

Cash based budgets take into account the cash inflows and the cash outflows made in a period of time. They are specific to the public budgets, corresponding to the system of budgetary management. In these budgets, the revenues part is reserved to the expected cashed incomes for the reference period, regardless of whether these entries are represented by outstanding, current or future incomes. Similarly, the expenditure part covers the payments made in the reference period, without taking into account the period for which these payments are made.

A correct forecast of the cash inflows and outflows helps the public entity to manage properly the

cash flows, without creating short term or medium term liquidity crises.

Estimating precisely the revenues and payments allows making financial investments (in accordance with the applicable legislation: term deposits, shares, securities, precious metals etc.) with a high return, without having to take on the penalties (penalties for closing accounts before the maturity or penalties for being late, for not paying the debts on time).

Cash based budgets must be balanced, or register a surplus (even an insignificant one). The deficit would lead to incapacity of pay as a consequence of the lack of liquidities for payments. The surplus reflects the weak capitalization of the sums available through investments.

The structure of the budget must be similar to the one that will be used in the regular financial reports. In the income part, the current revenues will be placed first (related to the taxes collected), followed by the exceptional revenues (such as the capitalization of fixed assets) and the financial ones (contracted credits, reimbursements of loans, revenues from the withdrawal



of deposits, tax refunds from the budget, etc.). A distinct position is occupied by the report of the previous period that can be used in the new budgetary year.

The surplus or deficit computed as a difference between the cash inflows and outflows made in a period reflects the situation at the end of the reference period. Registering a balanced budget or a surplus does not guarantee the absence of liquidity problems during the reference period. Taking into account the difference between the incomes on landed resources and the cost of attracting borrowed resources on the short term (if the legislation allows it), it is necessary to identify as accurately as possible the treasury gaps. Drawing the budget for shorter periods of time (trimesters, months, decades or weeks) and then summing up these budgets guarantees a higher degree of accuracy regarding the costs and the benefits of the financial activity. In some situations, in order to facilitate the current financial operations during the budget year these aspects were left out of the budget.

The role of the cash based budgets is that of ensuring the management of the treasury activities. This financial document must accurately sum up the level of

the sums that must be released for making payments and the sums that can be placed on a limited term. Based on these data the revenues and the financial expenses (especially the ones related to interest) can be established.

The treasury budget is the base for the accrual based budgets, offering their main indicators. Unlike the previous one, the cash based budget does not offer enough data regarding the level of revenues and spending, but it is able to offer only the information necessary to substantiate them.

## **2.2 Accrual Based Budgeting**

Accrual based budgeting shows the accounting income and expenses of the entity, recognizing them when they become due, regardless of the moment of cashing in (this moment can be previous, simultaneous or prior to the moment in which the income is registered) or the moment of the payment (in this case too, we can

have payments made in advance, simultaneous payments or prior payments).

The accrual based budget maintains from the cashed based budget only those components that will be registered in the income and spending accounts for the same reference period. Additionally, the accrual based budget also contains the payments from the previous cash based budgets that are expected to be registered in the reference period. The revenues and spending that will be cashed or paid in the following periods (commercial credits, arrears etc) will be included in the accrual based budgets, even though they do not appear in the cash based budgets.

As it was shown, there is a strong connection between cash based budgets and accrual based budgets. The correlations are presented in detail in table no. 1.

Table no. 1: Correspondence between cash budgets and accrual budgets

	Budgets before reference year (<n1)		Budgets from reference year (n)		Budgets after reference year (>n)	
	Cash budget	Accrual budget	Cash budget	Accrual budget	Cash budget	Accrual budget
<b>Incomes/Expenditures</b> - Cashed/ paid <n, recognized in n - Cashed/ paid in n, recognized in n - Cashed/ paid >n, recognized in n	✓		✓	✓ ✓ ✓	✓	
- Cashed/ paid in n, recognized <n - Cashed/ paid in n, recognized in n - Cashed/ paid in n, r recognized > n		✓	✓ ✓ ✓	✓		✓

Since the accrual based budgets and the cash based budgets are using different principles, there are differences between these two budget types. The main differences are presented in table no. 2.

Table no. 2: Budgetary indicators on budget types

Budgetary indicator	Cash budget	Accrual budget
INCOMES		
- taxes and fees owed		x
- taxes and fees paid (including arrears)	x	
- cashing from selling assets	x	
EXPENDITURES		
- acquisitions of goods and services		x
- payments of goods and services	x	
- salaries and similar rights (including employers' contributions) owed to employees		x
- salaries and similar rights (including employers' contributions) paid to employees	x	
- asset acquisition	x	
- amortization		x
- unamortized value of sold assets		x

The accrual based budgets are used on a more reduced scale, but in the last years important steps have been taken to extend them. The migration from cash based budgeting to accrual based budgeting is done gradually, especially by completing the information from the cash based budgets with specific information from the accrual based budgets.

### **3. Developing the Budgetary Performance Indicators**

The performance indicators have the role of offering correct, complete, subjective and unbiased information about the results obtained by a certain agency, making it possible to sum up the degree of reaching the targets imposed by the financer. The agency's financing decisions can be based on this information.

The budgets based on performance indicators are the alternative solution found for eliminating the shortcomings found in line item budgets. Line item

budgeting has a series of deficiencies related to the fact that it does not provide guidance as a policy or decision making tool (Nispen and Posseth, 2009). Budgetary performance indicators are meant to increase the efficiency and the efficacy of the way in which funds are used. The financer (the principal from the agency theory) must take the decision regarding the prioritization and the financing, taking into account the results that are supposed to be obtained by the agents.

The process of implementing a system of budgetary performance indicators can encounter some difficulties that must be surpassed. These obstacles are caused especially by: the agents' desire to obtain financing that is as large as possible, even if their results are not in accordance with the financing, by the institutional system, the unfair competition between agents.

The performance indicators must support the financer and help him substantiate the decision for the financial allocation. In most cases, the monitored indicators and their values are established by the agents. Due to this, they want their reporting to be used

for the substantiation of the decisions, not just to be formally requested (Grizzle, 1987).

The implementation of performance based budgeting has been done differently around the world. Thus, there is no standard model, but a series of cases that have some common aspects and numerous particularities. Robinson and Last (2009) have tried to find the simplest budgeting model, whose implementation doesn't require significant financial and human resources. In order to do this, certain elements are necessary:

- information about the objectives and the results obtained through the use of public funds;
- a budgetary process that can predict the way in which the information regarding performance is use;
- using the program budgets;
- medium term budgeting.



#### **4. Strengthening the Budgetary Transparency**

The budget is the financial interface between the internal environment and the exterior environment of the entity. In order to ensure a good flow of information from the internal environment to the exterior one, and in order to fulfill the conditions for optimum monitoring and for the control of the entity, it is absolutely necessary to have transparency in all the phases of the budgetary process.

Budgetary transparency allows the strengthening of budget procedures, the integration of accrual and cash accounting, and the removal of gimmicks that bypass fiscal constraints (Reviglio, 2001). In this way, positive results can be obtained both through the increase of the revenues, as well as through the reduction of spending, which results from the improvement of the administration of the budget. The transparency involves ready access to reliable, comprehensive, timely, understandable, and internationally comparable information on government activities permitting electorate and financial markets to accurately assess the government's financial position

and the true costs and benefits of government activities, including their present and future economic and social implications (Kopits and Craig, 1998). Transparency in the governmental sector must be permanent in all the sectors and in all the phases of the budgetary process.

The most complete and professional approach of the principles of good practice regarding the budget transparency can be found in “OECD Best Practices for Budget Transparency<sup>1</sup>”. The main parts of the transparent budget administration are summarized in a few pages and the recommendations that can maximize transparency are presented. Thus, transparency must be materialized through openness about policy intentions, formulation and implementation. The authors consider that budget transparency can be ensured by elaborating regular budgetary reports (pre-budget reports, monthly reports, mid-year reports, year-end reports, pre-election reports, and long-term reports), by explaining the economic context for implementation, supplying some control levers, and auditing.

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<sup>1</sup> This article can be read in Budgetary Research Review vol. 1 no. 1

The behavior and the requirements of the citizens can influence the public sector's efficiency. From Amoroso's economic model (2008) we find that the reduction of the unproductive activities from the public sector can be done by increasing the transparency of the budgetary process.

## **Conclusions**

The budgetary reforms appeared, in most cases, in unfavorable economic conditions (recessions, crises, acute macroeconomic disequilibria). From this point of view, there couldn't have been a more favorable period of the last century for introducing new rules that would ensure a higher transparency regarding the use of public funds and their better use. All the states of the world and the local administrations have what to improve, even though some are more advanced and others are in an incipient state.

The experience accumulated up to now at the level of the administration of the budget helps us identify the best way that should be followed: introducing budgetary performance indicators in the phases of the budgetary execution and using them in an objective way to substantiate and evaluate the activities, in order to ensure the efficiency and efficacy of the use of public funds. What is not exactly known is the implementation method and the instruments that should be used so that a better assimilation of these economic measures is created (especially in the public economy). The essential aspect is creating a system of relevant indicators that can be trusted with regard to the economic environment, that are easily quantifiable, exact, hard to manipulate by the reporting agents and are transparent.

The states that have started their budgetary reform more than two decades ago are the documentation source for the states that have started their reform later. The best practices that can be taken from the experience of states such as New Zealand, Australia and the United States of America should guide the actions taken by the states that are looking for the optimal solution. The example taken from a state,

without having previously been adapted to another state will not render benefits, but it can be the starting point, since it can have better results than those that can be obtained through an original local method.

On the medium term, the budgetary performance indicators must be incorporated in the budgetary decision so that the financing decision reflects a direct proportionality between the degree of realizing the indicators and the appropriations. The decisions regarding the improvement of the mechanisms will lead to a better system, but only after the efficiency of the basic principles is confirmed. Up to now, we cannot talk about the success of a method, due to the lack of some key parameters: budgetary transparency, professionalism in public management, the desire to make public spending more efficient.

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