

## Unit 2: Introducing the budget

### Learning objectives What are the components of the Budget?

After studying this unit you should be able to:

- Define the budget and its components
- Discuss possible effects of high deficits
- Understand the principles of good budgeting
- Explain the three objectives of public expenditure management

### **Introduction**

In the most general definition, budgeting is concerned with the translation of financial resources into human purposes.

Aaron Wildavsky, 1984

What is a budget and what purpose does it serve? This unit introduces the budget and some related core concepts and terminology. The following sections consider the definition and components of the budget, and the objectives of budgeting as proposed by current public expenditure management theory.

### **Definition and components of the budget**

The word budget developed from *bougette* or 'small bag' in middle French. The use of the word spread to England, where it came to designate the leather bag in which ministers of the crown carried financial plans to parliament, and eventually it became synonymous with its contents. The use of the word in the United Kingdom now refers to the spring financial statement, which focuses on taxation measures. In most countries, the term refers to the annual expenditure and revenue plans tabled in the legislature.

The first traceable legal definition of the budget is contained in a French decree of 1862: 'The budget is a document which forecasts and authorizes the annual receipts and expenditures of the State...' (Stourm 1917, p. 2). In most countries, the government budget is drafted at regular intervals by the executive and tabled in the legislature for review and approval before the beginning of the fiscal year to which it applies.

### **Box 1: Origins of the fiscal year**

In early budgeting, there was a clear link to the crop cycle. Once the harvest was in, one could make plans for the next year. Many developing countries have maintained this connection by clinging to the broken budget year. In India, the revenue for the subsequent year can only be assessed after the Monsoon season in May, June and July. But agriculture is not the only source of income to be taken into account in the Third World. Papua New Guinea changed its budget year to fit that of the donor countries, since their contributions were so decisive for the government's economic planning. In other parts of Asia, governments hesitate between the lunar and the solar calendars. Over time, there has been a tendency to converge on the calendar year as the most convenient basis for budgeting. While the United Kingdom has held out with a budget year beginning in April, Sweden gave up the broken budget year to adopt the calendar year model in 1995. In the long discussion preceding this decision, it was claimed that a harmonization both upwards (towards the European Union) and downwards (towards private enterprises, communes and regions which had long practiced calendar year budgeting) would bring about greater transparency and facilitate coordination between different levels.

Source: Tarschys (2002).

Sources of income vary substantially between countries. They usually include direct taxes, which are levied on income or capital, for example income tax. Such taxes are called direct because it is normally assumed that the real burden of payment falls directly on the person or firm that is immediately responsible for paying them. By contrast, indirect taxes such as sales taxes or excise taxes on alcohol and tobacco are so called because it is assumed that the real burden of paying the tax will not fall on the firm immediately responsible for paying it but rather that it will be passed on to the customer. Other sources of government income might consist of user charges for certain services, foreign aid, and income from investments or commercial activities.

In considering its revenue raising options, the government has to weigh advantages and disadvantages. For example, boosting reliance on sales taxes makes taxation more regressive. This means that a poor person will pay as much tax as a rich person when purchasing an item of clothing or food, as sales tax does not take account of income differentials. On the other hand, income taxes are progressive when they apply higher

rates to individuals with a higher level of income. But where the formal economy is small, excessive taxation of a few high income individuals can undercut investment, which hampers growth and employment creation. Over time, this might erode the tax base and reduce the ability of government to raise revenues. Raising an adequate amount of revenues, while at the same time preserving equity and stimulating economic growth, can be a difficult balancing act.

On the expenditure side of the budget, government allocates funds to various functions such as health care, education, agriculture, justice, defense and so on. This is called the functional classification of expenditures. The share of total expenditures allocated to each sector is a key indicator of spending priorities for a given year and of shifts in priorities over a period of time. In terms of the economic classification of expenditures a distinction can be made between current and capital expenditures. Current expenditures are on goods and services that are consumed immediately, for example wages of civil servants or supplies of learning material for schools. Capital expenditures comprise money spent on the purchase of goods that can be used to produce other goods, for example machinery or infrastructure. The balance between current and capital spending is important. When a clinic is built and equipped to service a community (a capital expenditure), then government has to make sure that it sets aside sufficient funds to run the clinic on a day to day basis, which requires budgeting for wages, medicines and the like (current expenditures).

When government spends more money than the available revenues, it can either raise taxes or budget for a deficit and cover the shortfall with borrowed money. There is a wide range of alternate deficit measures, but the conventional deficit is widely quoted as perhaps the central indicator of fiscal health. This deficit measure is defined as the excess of government's total expenditure over total revenue. There is no absolute figure that can indicate whether the deficit is too large, which depends on the size of the economy. For this reason, the deficit to Gross Domestic Product (GDP) ratio is used to indicate the share of national income that will have to be used to finance the deficit. Although the appropriate size of the deficit depends on a variety of factors that determine sustainability on a case by case basis, one rough but widely accepted

benchmark was set in the European Union's Maastricht Treaty with a figure of three per cent of GDP. However, some go further and demand balanced budgets where revenues are equal to expenditures. Changes in the deficit do not have to be the result of a shift in fiscal policy, but can also reflect the business cycle, for instance. Consistently growing deficits, however, give cause for concern:

- Government borrowing can put upward pressure on interest rates so as to 'crowd out' private sector investment. In other words, when government uses most of the capital available on the borrowing market, less is available for the private sector to borrow in order to expand its activities. This can dampen economic growth.
- Deficit spending is expensive. Because government will have to put aside a proportion of funds to service its stock of debt, there will be less money for service delivery. Reductions in service delivery programs affect vulnerable groups in society that are most dependent on the state.
- It is unfair if extensive borrowing forces future generations to make sacrifices so that they effectively pay for spending that we enjoy today. This problem is exacerbated when borrowed funds are not invested productively.
- Excessive deficits are associated with inflation. Some governments have resorted to 'printing money' in order to meet debt servicing obligations. However, this strategy is difficult to pursue when the central bank enjoys entrenched independence from the government both legally and in practice.

### **Box 2: Principles of good budgeting**

**Comprehensiveness:** The budget must cover all the fiscal operations of government, encompassing all public expenditure and revenues, to enable full and informed debate of the tradeoffs between different policy options.

**Predictability:** Spending agencies should have certainty about their allocations in the medium term to enable them to plan ahead. Stable funding flows support departmental planning and efficient and effective delivery.

**Contestability:** No item in the budget should have an automatic claim to funding. All policy and attached funding should be regularly reviewed and evaluated in order to ensure prioritization and optimal performance of spending agencies.

**Transparency:** All relevant information required for sound budgetary decision making should be available in an accessible format, and in a timely and systematic fashion. Budget information needs to be accurate, reliable and comprehensive.

**Periodicity:** The budget should cover a fixed period of time, typically one year, and the process of compiling the budget should follow a clear and reliable schedule that is agreed upon and published in advance.

Source: World Bank (1998).

## Objectives of budgeting

If resources were limitless, we could all get whatever we want from the government. There would be no need to budget. In reality, spending needs are inevitably beyond available funding. Governments have to make choices about the allocation of scarce resources to meet competing needs in society. Budgeting is effective in facilitating this process when it forces awareness of overall fiscal constraints, enables the prioritization of spending in line with policy objectives, and supports the efficient implementation of policies.

Table 1 Basic elements of public expenditure management	
Objective	Requirements
<b>Aggregate fiscal discipline</b>	Budget totals should be the result of explicit, enforced decisions; they should not merely accommodate spending demands. These totals should be set before individual spending decisions are made, and should be sustainable over the medium term and beyond.
<b>Allocative efficiency</b>	Expenditures should be based on government priorities and on effectiveness of public programs. The budget system should spur reallocation from lesser to higher priorities and from less to more effective programs.
<b>Operational efficiency</b>	Agencies should produce goods and services at a cost that achieves ongoing efficiency gains and (to the extent appropriate) is competitive with market prices.

Source: Schick (1998).

Aggregate fiscal discipline refers to the control of the key measures of fiscal performance, including total spending, total revenue, the financial balance and the public debt. Fiscal discipline requires that budget totals are the result of explicit and

enforced decisions. Many factors are important for determining the appropriate total level of aggregate spending, including available revenues, access to borrowing and the acceptable level of the deficit. Given these constraints, fiscal discipline calls for affordability of total spending, including in the medium to long term. Some countries have adopted formal rules to ensure fiscal discipline, for example by allowing borrowing for capital purposes only (the so-called 'golden rule'). A strong treasury or finance ministry can check that spending departments do not make exaggerated claims on the budget and that they stick to their budgets once they have been approved. A hard budget constraint on departmental spending exists when the treasury is successful in enforcing approved budgets. This requires comprehensive and reliable information to monitor compliance of government departments with spending plans. To safeguard fiscal discipline, parliament has to resist the temptation to add new spending without commensurate cutbacks elsewhere in the budget.

Because resources are limited, budgeting forces us to consider the merit of competing claims on the public purse and to negotiate tradeoffs between them. The achievement of allocative efficiency or strategic prioritization requires government capacity to allocate resources and select programs and projects in conformity with its objectives. This process is supported where the policy basis of the budget is stated clearly on the basis of a medium term strategy. Allocative efficiency is threatened where spending departments are bailed out when they overspend, because poor budget execution can introduce substantial ad hoc realignments that distort stated priorities. Such distortions often divert resources away from the poorest and most vulnerable groups in society to cater for the interests of bureaucracies and strong interest groups. Parliament can provide an important platform for public debate on the nation's priorities.

Once funds have been allocated they should be spent so as to deliver maximum results. Operational efficiency is the ratio of the resources expended by government agencies to the outputs produced or purchased by them. Spending departments should strive to eliminate waste and produce goods and services at a cost that achieves ongoing efficiency gains. To provide managerial incentives for operational efficiency high level civil servants can be given performance contracts that spell out clear objectives and

targets. Moreover, effective parliamentary scrutiny and accountability for results can support a mind shift in spending departments from a mentality of compliance to one of achievement. Parliaments increasingly consider not only the allocation of money, but also what is delivered with that money. To facilitate legislative review of departmental performance the format of the budget needs to go beyond the traditional focus on cost and inputs. Also needed is information on strategic objectives, output targets (the amounts of goods and services to be delivered) and outcomes (the effects or impact of the activities carried out on the community). Parliamentary scrutiny of audit findings also strengthens accountability for performance.

### **Box 3: Budgeting for performance**

Performance budgeting has been a prominent theme in budget reform for several decades. Such efforts have taken many forms, and success varies. One reason is that the idea of performance budgeting is appealingly simple, but very difficult to implement in practice. A broad definition of a performance budget is one where the budget presents information on what departments have done or expect to do with the money provided to them. Many countries are now providing such information as part of their budget documentation. More strictly defined, a performance budget is only a budget that explicitly links each increment in resources to an increment in outputs or other results. There are very few successful examples of performance budgeting in the stricter sense, and New Zealand is arguably the country that has taken this approach furthest.

Source: Schick (2003).

The objectives of aggregate fiscal discipline, allocative efficiency and operational efficiency are interrelated. In many ways fiscal discipline comes first. For example, politicians often promise improving macroeconomic conditions such as higher growth, less unemployment and lower inflation, all of which impact on the amount of revenues government expects to collect. Overly optimistic revenue forecasts are politically tempting because they create an imaginary space for promises of more money on services. The inevitable revenue 'shortfalls' result in higher deficits or necessitate expenditure cuts that distort spending priorities so that allocative efficiency is undermined. In-year spending cuts also undermine predictability, which is an important prerequisite for operational efficiency in departments. To be transparent government should publish the macroeconomic assumptions and projections upon which the budget is predicated. It is a good test of government's budgetary foundation to consider whether its growth forecasts are substantially more optimistic than those produced by the private sector and international organizations. If this is the case, it is rather likely

that the budget is unsound. Unrealistic assumptions about improvements in revenue collection are another symptom of escapist fiscal planning. Such tactics threaten to undermine the objectives of budgeting.

#### **Box 4: A note on fiscal decentralization**

Decentralization of central functions to lower level government units has become an important element of public sector reform in recent years. It is hoped that decentralization can promote local innovation, match services with local preferences, and that greater accountability to local communities can achieve more efficient provision of essential services where central government has not been able to deliver. However, in the initial stages of decentralization, there are often capacity bottlenecks at the subnational level. For this reason, fiscal decentralization should be complemented with adequate oversight and accountability mechanisms to ensure that the process of decentralization is managed optimally and to guarantee equitable access to services. For instance, the legislature should have access to detailed spending information across levels of government, and it should scrutinize the underpinning revenue sharing arrangements.

## **Conclusion**

Budgets are regularly produced financial plans of the government comprising revenues and expenditures of the state. They should be comprehensive and transparent and ensure funding predictability for government departments. Public resources are always limited and inevitably fall short of meeting all the needs of society. For this reason the budget process is used to assess competing claims on the budget and to facilitate difficult tradeoffs. Meeting this challenge successfully requires that budgeting achieves and maintains fiscal discipline, the strategic prioritization of public funds, as well as sound operational management.

## **Unit 2 Questions**

Please answer each of the following questions. If you are taking this course in a group you may then meet to discuss your answers.

- Does it matter if governments have high budget deficits?
- List some of the main sources of government revenue. Which of these are important in your country?
- How does the budget in your country compare to the principles of good budgeting?
- Are fiscal discipline, allocative efficiency and operational efficiency the only objectives of budgeting?

### **Relevant internet resources**

American Association for Budget and Program Analysis:  
<http://www.aabpa.org/>

Governance Resource Centre Exchange:  
*Public Financial Management and Accountability*  
[http://www.grc-exchange.org/g\\_themes/pfma.html](http://www.grc-exchange.org/g_themes/pfma.html)

International Monetary Fund:  
*Guidelines for Public Expenditure Management*  
<http://www.imf.org/external/pubs/ft/expend/index.htm>

Overseas Development Institute:  
*Centre for Aid and Public Expenditure*  
<http://www.odi.org.uk/pppg/cape/>

Public Budgeting and Finance:  
<http://www.blackwellpublishing.com/journal.asp?ref=0275-1100&site=1>

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