

# **Budget Theories**

## **An Economic Perspective**

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# Budget Theories: An Economic Perspective

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## Abstract

Budgets are the financial plans of expenditures made for a defined period to evaluate performances of programs, employees and departments within organizations, governments, and businesses. Governments use public budgeting to decide how funds will be allocated to accommodate the conflicting needs of society. Budgeting satisfies multiple government functions as the allocation of resources is political. Understanding the impact of reforms is important prior to attempting to put the reforms into effect. Budget allocation issues must allow for the macro and revenue issues. Since the allocation of budgets do not guarantee accuracy or effectiveness, the integration of social concerns into planning continues to be a topic of discourse.

A budget theory is a process that is used to establish a framework on how to proceed with the allocations of funds. Throughout the years, the public budgeting has changed drastically. The budgeting process entails a lot of factors which need to be considered before finalizing the budget. Due to the multiple factors and changes, many economists argue that one consistent theory is not sufficient to address the complexity that budgeting entails. This article observes budget theory through an economic perspective by examining the roles of public budgeting and the lack of consistency that exists as both a weakness and strength deriving from a single framework.

**Keywords:** public budgeting, budget theory, allocation, framework, government, economists.

## Introduction

Public budgeting is a field of public administration (Smith & Lynch, 2004). As a discipline in the academic study of public administration, budgeting is characterized by its approach, functions, formation, and type (Ibid.). While budgeting can be viewed from four different perspectives, this paper looks at budgeting through the perspective of economists (Smith & Lynch, 2004). According to Smith & Lynch (2004), economists view budgeting as a matter of allocating resources in terms of opportunity costs, where allocating resources to one consumer takes resources away from another consumer. Therefore, the economist's role is to provide decision-makers with the best possible information (Ibid.).

As a field of study, public budgeting has grown immensely in both structure and material (Khan & Hildreth, 2002). With such growth comes the need to have a consistent theory or frame of theories that enables the understanding of the field, its essential foundation that directs its development, and its capacity for dealing with real-world problems (Khan & Hildreth, 2002). Budget impacts the entire country by playing roles in politics, economics, management, and accountability (Mariafrancesca & Steccolini, 2017).

In 1940, political scientist V.O. Key recognized the need for budgeting theory (Khan & Hildreth, 2002). Keys created his theory on the same foundation that directed the economists to search vigorously for a function that would improve the welfare of society within the broader structures of the Paretian principle (Ibid.). Why did theories emerge, and what gives them momentum to

grow and continue? From Keys to Verne Lewis to other economists such as Arthur Smithies, attempts have been made to address the issues of public budgeting not having a theory of its own by offering a microeconomic solution to problems (Ibid.). This article examines the economic causes for the need for budget theory, the different roles that the public budget plays, and the lack of cohesion that exist as both a weakness and strength that derives from a single framework, which may present the danger of budgeting becoming too overwhelming by quantity and diversity of perspective that may lead to confusion (Ibid.).

## The History of Budgeting

The history of budgeting began during the declaration of the Magna Carta by King John in 1215 AD in England (Government Budgeting and Theories of Budgeting, 2017). In 1689 AD, the Bill of Rights authorized the need for parliamentary approval on raising tax, debt, and donations by the government (Ibid.). In 1733 AD, the first budget was presented in the parliament in England (Government Budgeting and Theories of Budgeting, 2017). Since that time, public budgeting has grown tremendously (Khan & Hildreth, 2002). With the growth derives a need to have a coherent theory or body of approaches that will enable an understanding in the field, important essential that guides its development and its possibility for dealing with real-world problems (Ibid.).

In 1940, the need to have a theory for budgeting was acknowledged by V.O. Key (Khan & Hildreth, 2002). In his famous piece, "The Lack of a Budgetary Theory", Key addressed the issue of public budgeting not having a theory of its own by offering a microeconomic solution to the problem (Ibid.). Key's solution would consist of allocating government efficiency. Key-based his theory on the rationale that also guided economists to seek endlessly for a function that would improve the welfare of society within the broader schemes of the Paretian principle (Ibid.). The Paretian Principle states that 80% of consequences derive from 20% of the causes and commonly is used to illustrate the notion that not all things are equal, and that the minority owns the majority (The Investopedia Team, 2020). However, while other economists offered similar views as mainstream welfare economists, budgeting is more than simply allocating the scarce resources between one and another activity (Khan & Hildreth, 2002).

Traditionally, budgeting has been referred to as the process through which governments decide how much to spend on what (Mariafrancesca & Steccolini, 2017). Expenditures are limited to the available revenues to prevent overspending (Ibid.). Throughout time, public budgets have taken on different roles: therefore, becoming tools for bargaining and allocating power, planning, and controlling, providing instincts to the economic and social environment, and ensuring transparency and stakeholder involvement (Ibid.). Budgets play political, economic, managerial, and accountability roles. Budgets perform a political function by reflecting stakeholders' preferences and power positions (Ibid.). Budgets define the boundaries of public intervention in the economy and the degree of rearrangement of wealth in the economic system. Budgets also hold managers accountable for attaining results and the use of public resources (Ibid.). In doing this, budgets fill the managerial function. Budgets serve an external accountability function by holding public organizations accountable to the general public (Ibid.).

Budgeting is about meeting the conflicting needs of society by bringing about compromises in the political marketplace through incremental adjustments in budget allocation (Khan & Hildreth, 2002). Some economists argue that it is not necessary to have a single theory of budgeting but

rather a set of ideas unique to the problem budgeting is trying to address (Ibid.). The different roles that the public budget plays highlight the vast concerns why it is so difficult to have a single theory that can tie all of the elements into a coherent theme (Ibid.). The lack of cohesion serves as both a weakness and a strength as not having a single framework always presents the danger of the field being too overwhelmed by the quantity and the diversity of perspectives that may be confusing (Ibid.). On the other hand, while overwhelming, the strength is the completion between quantity on one side and the diversity of inquiries that will shape and help develop a comprehensive budgeting theory (Ibid.).

## The Budget Process

According to Ganti (2021), a budget is an estimation of revenue and expenses over a specified future period. A budget is often compiled and reevaluated periodically. Budgeting keeps track of how much money is earned and spent and provides an understanding of where money is spent (Ibid.). A budget is a microeconomic concept highlighting the trade-off made when one good is exchanged for another. The result of the trade may be one of three types: surplus, a balanced budget, and a deficit. A surplus budget refers to anticipated profits. A balanced budget refers to revenues expected to equal expenses, and a deficit budget refers to expenditures that will exceed income (Ibid.).

A budget process is necessary for organizations to plan and prepare budgets for set periods. There are six goals to a budgeting process. The first is to aid in planning actual operations (Corporate Finance Institute, 2022a). The process gets managers to consider how conditions may change and what steps are needed. The second step is the coordination of the organization's activities (Ibid.). Budgeting encourages managers to build relationships with other parts of the operation and understand the various departments and teams' interactions (Ibid.).

Another goal of budgeting is the communication plans to different managers that ensure a clear understanding of how to support the organization (Corporate Finance Institute, 2022a). Motivating managers to strive to achieve the budget goals to focus on participation, the budget process is another goal that can be challenging (Ibid.). Controlling activities to compare actual spending with a budget to control financial activities and evaluating managers' performance as a means of informing managers of how well they are performing in meeting targets are also essential parts of the budgeting goals (Ibid.). However, any shift in the macroeconomic conditions, like an economic downturn or change in currency exchange rates, changes in interest rates, and so forth, can lead to actual costs that vary from the budgeted expenses (Borad, 2022).

Budgeting falls within the jurisdiction of bureaucracy in almost all forms of government budgeting (Budgeting: Theory, development, and performance, 2015). The jurisdiction of public administration, which is operated and overseen by civil servants, prepares the budgets (Budgeting: Theory, development and performance, 2015). Budgeting is an essential function of bureaucracy; however, alone cannot do everything about budgeting (Ibid.). In a parliamentary system of government, all departments are led by a minister (Ibid.). The head of the finance department is referred to as a finance minister. The preparation of the estimated expenditures and income is done under the finance minister's guidance (Ibid.).

Budgeting has undergone several changes (Budgeting: Theory, development, and performance, 2015). Some of the changes include the traditional or line-item budgeting with its control orientation, performance budgeting that emphasizes the results of money spent by the government,

and planning-programming budgeting that focuses attention on the preparation of planning for economic progress and estimates success and actual success achieved (Ibid.).

Budgeting involves governments' finance, including social, economic, and political activities and policy measures (Government Budgeting and Theories of Budgeting, 2017). Government budgeting is at the center of the public economy (Ibid.). While budgeting can be defined as a financial plan of government or the legal authority for public spending, the features of a budget include a financial plan or program guided by socio-economic policy, a plan of action with the approval from the legislature, an annual plan is directed by and intended to achieve the socio-economic objectives, a process involving the formulation, approval, execution and monitoring, and evaluation and include all estimated revenues and expenditures (Ibid.).

## Types of Budgeting

Four common types of budgets are used (CFI Education Inc., 2022). The first type of budgeting is Incremental budgeting. Incremental budgeting is based on slight changes from the preliminary budget or actual results (Bragg, 2022). Incremental budgeting utilizes the preceding year's actual figures and adds or subtracts a percentage to obtain the current year's budget (Ibid.). Incremental budgeting is the most common method because it is simple and easy to understand (Ibid.). Incremental budgeting is designed to ensure that funds will keep flowing to a program that requires funding for multiple years to achieve certain outcomes (Bragg, 2022). If the primary cost drivers do not change year-round, incremental budgeting is the most appropriate budgeting (CFI Education Inc., 2022).

However, incremental budgeting does have its disadvantages. Incremental budgeting is more likely to perpetuate inefficiencies (CFI Education Inc., 2022). Suppose a person knows that there is an opportunity to grow the budget by 10% every year. In that case, the person may take that opportunity to attain a larger budget while not putting enough effort into seeking ways to cut costs or economize (CFI Education Inc., 2022). Incremental budgeting is incremental (Bragg, 2022). It assumes only minor changes from the previous period when major structural changes may call for more significant budget alterations (Bragg, 2022). Incremental budgeting also fosters overspending by perpetuating an attitude of "use it or lose it" concerning budgeted expenditures (Ibid.). When based on a previous budget, an incremental budget creates a growing disconnect between the budget and actual results. Incremental budgeting may be difficult to obtain a large funding allocation to direct new activity because an incremental budget allocates the majority of funds to the same uses every year. In summary, incremental budgeting leads to a conservative mindset that may lead to financial destruction in the long term (Ibid.).

The second type of budgeting method is Activity-Based. Activity-based budget is referred to as top-down budgeting (CFI Education Inc., 2022). The top-down budgeting approach determines the number of inputs required to support the targets or outputs set by a company (Ibid.). For example, suppose a company sets an output target of \$500 million in revenues. In that case, the company will need first to determine the activities to be undertaken to meet the same target and then determine the costs of carrying out those activities (Ibid.). The activities are termed activity costs, and after analysis of costs, a budget is created based on the findings (Indeed Editorial Team, 2022).

Activity-based budgeting may allow recording, tracking, and lowering expenses to reduce overall costs and improve efficiencies (Indeed Editorial Team, 2022). The accounting process occurs in

four steps (Ibid.). First, cost-incurring activities are identified. The second process is evaluating how many units of the activities are occurring. The third process consists of calculating the cost per unit of the activity or activities, and the fourth process is the multiplication of the costs by the level of activity. Due to the calculation, activity budgeting is considered more rigorous than traditional budgeting (Ibid.). Activity budgeting has other goals of reducing costs and improving efficiency, not simply monitoring expenses, or adjusting information based on inflation or other related happenings (Ibid.).

There are many benefits to activity-based budgeting. Activity-based budgeting provides better insights into operation costs because of its in-depth analysis of expenses and how they may affect the entire company's performance (Indeed Editorial Team, 2022). Activity-based budgeting helps companies reduce production costs, increase production efficiency, and determine how to make products more cost-friendly, thus providing an added competitive edge (Ibid.). With the integration of operations management and accounting in the budget process, activity-based budgeting enables more inclusion of a broader variety of staff and expertise (Ibid.). Activity-based budgeting enables companies to make budgetary decisions based on specific activity cost drivers, amounts, and importance to company activities (Ibid.). Activity-based budgeting can also cut costs to improve efficiencies (Ibid.).

Value proposition budgeting drives value (Divy, 2022). Value proposition budgeting requires a justification of expenses. Also referred to as priority-based budgeting, a value proposition consists of analyzing and justifying the value of every specific item on an expenditure list. Value proposition budgeting is often seen in government spending since the sector involves many financial restructures throughout the year (Ibid.).

Value proposition budgeting is different from activity-based budgeting in the sense that activity-based is goal orientated. Activity-based budgeting is issued to maximize cost efficiency; This means that activity-based budgeting is meant to meet the goals set by the government while trying to minimize extra costs and be efficient. A value proposition is less focused on cost efficiency and more focused on the value that the budget brings. Simply put, a value proposition asks why something is in the budget and intends to direct primary focus on the overall effect of the budget on the people that are being budgeting for. Value-based budget also involves less securitization and research than an activity-based.

Governments use these methods to decide which city services are most valuable and most needed by the community (Divy, 2022). Value proposition budgeting is preferred for determining where money should be allocated to generate more income and satisfy current and new consumers. However, it is also time-consuming and requires care planning (Ibid.). Within government funding scenarios, value can be difficult to quantify, where officials are required to ask how to value necessary community events and how to fit those events into the budget. Determining value can also be an involved process, and reassessing budget targets is very time-consuming (Ibid.).

In value proposition budgeting, the person who is doing the budgeting should consider why the amount is included within the budget, whether the item creates value for customers or stakeholders, and whether the item's value outweighs its costs? (CFI Education Inc., 2022). If the value does not outweigh the price, the budgeter would need to inquire if there is another reason why the cost is justified (Ibid.). In summary, value proposition budgeting is a mindset about ensuring that everything included in the budget delivers value for the company or government (CFI Education

Inc., 2022). Value proposition budgeting strives to avoid unnecessary expenditures despite not having a goal, and the final budgeting option is zero-based budgeting.

Zero-based budgeting is one of the most commonly used budgeting methods (CFI Education Inc., 2022). Zero-based budgeting begins with the assumption that all department budgets are zero and must be rebuilt from the beginning (Ibid.). In zero-based budgeting, every expense will require justification. No expenditures are considered essential to the company's profitable operation (Ibid.). The zero-based approach is most useful when there is an urgent need for cost containment in situations where a company or government is going through a financial restructuring or major economic downturn that requires the reduction of the budget dramatically (Ibid.). Zero-based budgeting is most appropriate for addressing discretionary costs rather than essential operating costs. Globally those who utilize zero-based budgeting report more success at meeting cost targets (Get in touch Omar Aguilar Strategic Cost Transformation Leader, 2021). Sixty-three percent of those who did not use zero-based budgeting did not meet their cost targets, compared to 58% who did use zero-based budgeting who did meet their cost targets (Ibid.).

## Analysis

While budgeting is synonymous with management accounting research, a cohesive or comprehensive budgeting theory is less equal (Kenno S. et al., 2018). More research may benefit from a comprehensive review of theories to advance understanding of the benefits and drawbacks of budgeting (Ibid.). Budgeting is not simply a plan for how money is spent or appropriated, but the first step in the budgeting process is the principal expressing the desired outcome (Williams & Calabrese, 2011). The starting point for the budget process is an expression of public goals to agency heads. (Williams & Calabrese, 2011). However, it is important that the public agency officials report back to the legislature what was accomplished toward these general goals (Ibid.). This makes budgeting not only about planning which government activities are funded and by how much but also requires an accounting of where public goals were met or not (Ibid.). Theorist Frank Goodnow's assertion was that budget theory should explain how money is distributed within government and why budgets should aid in meeting public plans and goals (Ibid.).

Due to its multifaceted nature, budgeting is viewed as being the subject of enduring interest by different disciplines, including political science, public administration, accounting, psychology, management, and organization studies (Mariafrancesca & Steccolini, 2017). Budgeting entails the interactions of different actors, cultures, professional identities, and disciplines that most likely account for the budgeting process's variety of approaches and forms (Ibid.). Public budgeting is a fascinating field and often the topic of investigation, which provides several insights into political, social, economic, and psychological processes. Budgeting represents the ideal setting for bringing in views from different scholarly communities and disciplines to show what can be learned by accepting that social, political, and economic processes are complicated and rich arenas (Ibid.). There is a continued need to explore budgeting theories in the public sector to look at the impacts and implications of evolving trends within the public sector (Ibid.).

Public budgeting has grown throughout the years (Khan & Hildreth, 2002). The growth in public budgeting has created a need to have consistent theories or frames of theories in order to better understand the field (Khan & Hildreth, 2002). The debate on the single theory of budgeting continues among those who argue that it is not necessary to have one single idea but rather a set of ideas. Due to its complexity, economists argue that a one blanket theory would be overwhelming

and confusing. With the many changes in budgeting, derives many types of budgeting methods that all offer advantages as well as disadvantages.

V.O.Key's 1940 essay "The Lack of a Budgetary Theory" was written because Key questioned budgetary decision-making. Key questioned the basis of the decision to allocate  $x$  dollars to activity A rather than activity B (Straussman, 1985). Despite many years of research and innovation, the question remains unanswered and will most likely remain unanswered (Key, 1981). Key's quest for an allocation formula has not only remained mostly unfulfilled but his conclusion about the influence of economics in the theory and practice of budgeting cannot be prolonged (Ibid.). Key's assertion that budgetary theory has been advanced is not able to be defended given the history of incrementalism. However, because incremental theory has become increasingly unsustainable as a complete theory of budgeting, the return to the theme of Key's classic essay is inevitable (Ibid.).

Key asserts that budgets are reflections of political philosophy and therefore making the search for an allocation formula to determine how best to distribute budgetary resources unreal (Straussman, 1985). Key understood that a solution to the problem will constitute a theory of government (Key, 1981). Key's article is an important reminder that budgeting is more than technique (Key, 1981). Unfortunately, the less of Key's essay is often forgotten when the latest reform comes to market promising a neat formula for dividing the budget (Ibid.). However, the lesson is remembered again when administrative and political pathologists seek cause and effect for the failure of the most recent promising innovation (Ibid.).

While Verne Lewis (1952) attempted to explain how the traditional microeconomics theory could be used to determine the relative value of a good or service to justify resource allocation that would improve social welfare, Wildavsky (1961) asserted that budgeting is more than allocating the scarce resources between  $x$  and  $y$  activities (Khan & Hildreth, 2002). Wildavsky insisted that budgeting is about meeting the conflicting needs of a society compromising in the political marketplace through incremental adjustments in budget allocation (Khan & Hildreth, 2002). However, the argument that it is not necessary to have one single theory of budgeting but rather a set of theories, each one being unique to the problem that the budgeting is trying to address, remains relevant (Khan & Hildreth, 2002). Sixty years after the work of Key, theorists continue to model behavior in hopes of finding explanations for budgeting in the government (Khan & Hildreth, 2002).

Budgets are tools used for the ability to support planning and effective management (Lidia, 2014). Preparing budgets can be difficult (Lidia, 2014). However, there are many benefits to budgeting (Lidia, 2014). Studies have shown that budget benefits exceed the overall disadvantages that they may cause (Lidia, 2014). Budgets continue to be used in economic entities. One of the main criticism of budgets is that they include long periods of time to prepare and incur a high cost. However, a study conducted by Lidia (2014) concluded that most people do not see the long period of time as a major problem.

Another criticism of budgeting is that they limit the adaptability and flexibility of the entity in the operating environment and are easy to manipulate (Lidia, 2014). Lidia (2014) concluded that those criticisms do not represent substantial disadvantages. While there are arguments regarding the disadvantage of budgets, increased difficulty of their preparation, and difficulty in achieving the required level of communication, coordination, and cooperation in order to make them, studies show that budgets are essential in their usefulness for planning and coordination (Ibid.). Studies



also show the budget's ability to maintain operational control and assist the unit in achieving objectives, as well as the ability to effectively manage resources and improve performances (Ibid.).

Budgeting plays an essential role within government entities (Norton, 2015). While the government budget has been at a deficit within reason years, balancing a budget is no doubt extremely difficult. Budgeting entails approaches addressing human rights, entitlements, accountability, and participation (Ibid.). Budgeting considers experience with gender-sensitive and pro-poor budget initiatives. Budgeting provides guidance on entry points, methodologies, and partners that can help strengthen voice, accountability, and responsiveness in the budget process (Ibid.).

Within the government, the budget helps determine the cause and claim of public financial resources as well as fulfilling economic, social, legal, and administrative functions (Norton, 2015). The importance of understanding the processes of policy and planning that complement the budget process is essential (Ibid.). The process of allocating resources is also fundamentally political. Getting the basic right before engaging in determined reforms is essential as well (Ibid.). Budget allocation issues cannot be distant from macroeconomic and revenue issues. Budget allocation can also not be assumed that allocations translate into accuracy in spending. Some argue that social concerns should be integrated into macro-planning. How and to what extent social concerns should be integrated continues to be debated (Ibid.).

Accountability and participation in the complex budget process are important (Norton, 2015). The tension between establishing statutory entitlements in budgets and retaining flexibility is often high (Ibid.). The need for establishing key entitlements to public provision on several conditions exists. Key entitlements to public provisions on provided on a non-discriminatory, citizenship basis and are established through a democratic process (Ibid.). The distribution of power within the budget process affects resource distribution. There is an unbalance of equal interests. Budgets that focus on outcomes rather than outputs may ensure that accountability provides more equitable outcomes for all citizens despite challenges that would need to be overcome (Ibid.).

## Conclusion

Budgeting is not simple. A single framework may become too overwhelming by quantity and a diversity of perspectives that may ultimately lead to confusion (Khan & Hildreth, 2002). Governing budgetary process is formulating the annual budget, managing its application, and ensuring its position with public goals (Organization for Economic Co-operation and Development, 2021). There are ten principles that are recommended to provide a concise overview of good practice across the diverse spectrum of budget activity (Ibid.). The recommendations are focused on implementation and improving budget systems to make a positive impact on people's lives. The recommendations also highlight the importance of budget principles to other aspects of good public governance, including integrity, open data, and the achievement of strategic goals (Ibid.).

The first principle includes managing budgets within clear, credible, and predictable limits for fiscal policy (Organization for Economic Co-operation and Development, 2021).

The second principle is to closely align budgets with the medium-term strategic priorities of the government (Organization for Economic Co-operation and Development, 2021).

Planning the capital budgeting framework in order to meet national development needs in a cost-effective and comprehensible manner, as well as ensuring the budget documents and data are open, transparent, and accessible, constitute the third and four principles (Organization for Economic Co-operation and Development, 2021).

The fifth principle is the presentation of a comprehensive, accurate, and reliable account of the public finances (Organization for Economic Co-operation and Development, 2021).

The sixth and seventh principles are actively planning, managing, and monitoring budget execution and ensuring performance, evaluation, and value for money are integral to the budget process (Organization for Economic Co-operation and Development, 2021).

Identifying, assessing, and managing sensibly longer-term sustainability and other fiscal risks, as well as promoting the integrity and quality of budgetary forecasts, fiscal plans, and budgetary implementation through carefully quality assurance, including independent audits, is the ninth and ten principles (Organization for Economic Co-operation and Development, 2021).

There are many lessons that can be learned with the experience of budget initiatives with social goals as well (Norton, 2015). Working successfully with social goals involves networks of different people, as many initiatives benefit from donor support, and successful initiatives are often part of broader political movements (Norton, 2015).

There are some factors that are recommended to promote accountability and gender-sensitive focus (Norton, 2015).

The first recommendation is a constitutional framework and political culture orientated to citizenship and rights, as well as a system of issues-based political competition (Norton, 2015). Sufficient fiscal resources for wider scale delivery of basic services so donors can take an important role in expanding the resources is a second recommendation (Ibid.).

Another recommendation is a clear framework of policy goals aligned to a vision for social justice (Norton, 2015). Budget allocation decisions should be transparent as well as budget execution systems because there is a particular need to strengthen the capacity to provide data (Ibid.).

It is strongly recommended to have an active civil society that can access information, produce analysis, and hold the government accountable because active and informed people are able to make claims on services and hold policymakers accountable. This involves access to information, development of skills, and allies capable of providing advocacy (Norton, 2015).

### ***About the Author***

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