

On the Performance Relevance of the New Budgeting and Accounting System in German Public Administration

- The Evolving Practice of Local Public Finance in Germany -

By Juergen Gornas

In Germany, the first article of local budgetary law states three central principles for sound financial performance and management at the local government level: (1) reliable fulfillment of public duties and responsibilities, (2) a balanced annual budget, and (3) thriftiness and efficiency in the management of the budget. While German local governments have become more thrifty and efficient in recent years—mostly out of necessity—the other two principles have moved further out of reach. With regard to these two principles, the reliable fulfillment of public duties and responsibilities and a balanced annual budget, two factors should be noted. First, the attainment of both principles is critical to achieving high quality output and outcome of public administration. Second, a balanced budget is the key prerequisite to fulfilling public duties reliably. A balanced budget reflects a sound financial condition of an entity which is necessary to fulfill public duties and to ultimately satisfy citizen needs.

At the subnational level, most democratic governments recognize the importance of budgetary balance to fiscal health; budget deficits lead to national economic deficiencies and thus undermine the common welfare in the medium to long-term. The failure of most local governments in Germany to live up to the basic principles of sound financial performance and management has led to the third budgetary system since World War II. Each new approach has brought changes in the organization and presentation of budgetary information as well as in the general possibility for performance oriented steering. This paper examines the evolution of budgeting and accounting systems in Germany over the years. It outlines the subsequent effects on the financial condition of local governments and specifically focuses on the importance of a balanced budget to the general effectiveness of using the budget as a steering instrument. In addition, this paper will discover whether the individual budgeting systems, especially the new budgeting and accounting system, are appropriate steering instruments to achieve efficacy and efficiency.

PAST – ORDINARY BUDGET/EXTRAORDINARY BUDGET¹

Germany's original budgeting system was based on a specific approach to public finance that attempted to minimize capital investments financed by the use of credit. This approach manifested itself in a budgetary structure split between an ordinary and an extraordinary budget. Both budgets treated revenues and expenses based on the concept of legal obligations (accrual basis); that is, they recognized the financial effect of transactions as they occur, regardless of the timing of cash flows.

The ordinary budget was the dominant component and thus the basis for balancing the budget. "Ordinary revenue" referred to all revenue that did not entail claims to repayment, including taxes, fees, grants etc. The budget was balanced when ordinary revenues covered not only operating expenses such as personnel, but also any debt service requirements and financial reserves for the modernization and extension of fixed assets. In addition, local governments were

required to transfer funds from the ordinary budget into a balance reserve (stabilization fund) to be used to cover expenses during financially challenging times and to limit the need for tax increases. This system was intended to eliminate the need to finance the modernization and extension of fixed assets through credit—a practice that left German local governments heavily indebted in the 1920s. Needless to say, financing all capital outlays on a pay-as-you-go basis was tremendously challenging during the rebuilding period that followed World War II.

The sources and uses of credit and sales revenues for capital outlays were included in the so-called extraordinary budget. The term “extraordinary” was meant to make it clear to citizens that local capital project activity and the use of debt was to be limited to a preemptory level. Like the ordinary budget, the extraordinary budget was based on the principle of individual coverage. This meant that revenues had to cover expenses for each department’s budget, and that the proceeds from the use of credit and the associated debt service were linked to the specific asset being financed. The capital project reserves were shown in department- or object-oriented special reserves.

This budgeting system, which was based on legal regulations predating World War II, continued until the late 1960s. The catalyst for a new system of public budgeting was the first post-war recession, which peaked in 1966 and 1967. Politicians had been pampered by steady economic growth up to that time, and they became convinced that the economy could not be left to its own devices—that Germany needed an instrument for steering the national economy. It did not take long before they focused their attention squarely on public budgets, especially the local budgets, which accounted for about two-thirds of all public capital projects.

PRESENT – OPERATING BUDGET/CAPITAL BUDGET²

While the politicians believed public budgets represented an efficient instrument for steering the national economy, the extant budgeting law did not provide for such steering by way of public budgets. Local political leaders did not have to factor national economics into their budgetary decision-making—just the needs of their particular jurisdiction. Intent on using local budgets for the purpose of economic steering, the federal and state governments initiated a complex new approach to public budgeting that affected even the relevant articles in the German constitution.

A macroeconomic dimension was added to the microeconomic focus of local budgets that required local governments to take into account the effects of their budgetary decisions on national economic equilibrium (steady economic growth, acceptable levels of employment, etc.). To this end, the federal government created the Financial Planning Council, a group that includes the federal finance ministers, the state (Länder) finance ministers, and four representatives of local government. The council establishes annual recommendations for the coordination of federal, state, and local financial planning and budgeting based on national economic demands. These recommendations include such things as the capital investment quota and the distribution of income tax revenues. This approach was institutionalized in the early 1970s and has characterized public financial management in Germany ever since.

Under the modified budgeting system, the use of credit no longer considered “extraordinary”, but rather an acceptable an even desirable means of paying for capital outlays. Furthermore, the principle of individual coverage has been replaced by the principle of “aggregate coverage”.

Debt proceeds and the associated principal and interest payments are no longer shown within the department budgets and their expenditure objects, but rather in a single location in the budget – the so-called “big pot”. Likewise, special reserves for the modernization and extension of capital assets no longer correspond to individual departments, instead, there is one common reserve.

This budgeting system has had a profound influence on the organization of local budgets. Instead of being divided between ordinary and extraordinary budgets, local budgets are now split into operating and capital budgets. Both the operating and the capital budgets use the cash basis of accounting; but for a few exceptions, revenues and expenses are recognized only when related cash amounts are received or disbursed. One noteworthy exception is depreciation. In the operating budget, depreciation is only shown within the budgets of the departments—if they collect fees that cover the total cost of depreciation. Otherwise, even if they have assets that are subject to depreciation, the departments will not include depreciation in their budgets. Anticipated disbursements associated with the financing and construction of capital projects are included in the capital budget, including principal payments, capital project expenditures, and the appropriation to the common reserve.

The modified budgeting system displays certain similarities with the old system. However, important differences exist. The budgeting system is no longer accrual based but rather cash based, and the principle of individual coverage has been eliminated. The two primary components of the budget have been reclassified. But most importantly, the “spirit of budgeting” has assumed an entirely new air. The old system considered the use of credit an extraordinary financing tool, whereas the modified system embraces debt as both acceptable and desirable.

In developing and balancing the annual budget, the operating budget is the determining factor. The regulations require that the difference between revenues (cash receipts) and expenditures (payments) in the operating budget be equal to or greater than the required principal payments in the capital budget, as this amount must be transferred to the capital budget. The financial condition of many German local governments is such that they can no longer meet this requirement. Consequently, these governments have issued new debt in order to make regularly scheduled principal payments on old debt. Local governments are no longer required to consider future modernization and extension of fixed assets in the operating budget by transferring funds for this purpose into the capital budget. Still, these governments collect fees from citizens for this very purpose—fees that take into account the depreciation of capital assets. Sadly, it has become common practice to use these funds in the operating budget for non-capital project purposes.

Considering the present state of local public finance in Germany, one must conclude that the modified budgeting system, with its emphasis on national economic needs, has not created positive results for local governments and their constituents. Local budgets are an ineffective means for compensating for lackluster growth in the national economy, and they have not been helpful in improving the employment situation. The most noteworthy result of the new approach to budgeting is the enormous mountain of debt that most local governments have accumulated over the last three decades. During periods of economic growth, local elected officials took no precautions against future downturns, preferring instead to assume additional debt in the name of economic development. While this is mainly attributable to the relaxed attitude toward the use of

credit, it has been exacerbated by the fact that the responsibilities of local governments have outpaced the growth of ordinary revenues..

FUTURE – INCOME BUDGET/CASH BUDGET³

Against this rather sobering backdrop, a substantial change is now taking place in German local government finance. North Rhine-Westphalia—one of Germany’s 17 states—has introduced a new budget law that includes some dramatic improvements in local government financial management compared to the existing system. In Germany, the states are responsible for establishing the budget laws for local governments. Local governments in North Rhine-Westphalia are required to implement this new budget law by 2009.

For the first time, all departments within a local government have a common accounting system, the double-entry bookkeeping system used in the private sector. Until now, two different accounting systems have been used. Administrative units use the traditional “Kameralistik” system, which captures revenues and expenditures but not balance sheet items such as fixed assets and borrowed capital. Legally independent entities such as utilities are included in the budget only in terms of the profit or loss. These entities use double-entry bookkeeping.

Also for the first time, local budgets will include not only inputs, but also goals and objectives with related output and outcome measures. As such, budgets will be oriented toward the future rather than the past.

Today’s cash-oriented budget will be replaced by a resource-oriented budget. For this reason, the new approach has been labeled the “total economic resources concept.” Under this new system, the budget will consist of an accrual-based budget and a cash-based budget. The accrual budget, or income budget, is equivalent to the profit and loss statement of private enterprise. Therefore, the rules for the integration of revenues and expenses into the budget are analogous to commercial and fiscal law for private enterprise. The accrual budget will account for the utilization of resources for all ongoing activities, regardless of the timing of related cash flows.

The cash budget includes all cash receipts and cash outlays for ongoing activities, financing activities, and capital project activities. This means that all ongoing activities are included in both budgets; for example, taxes are revenues in the income budget and cash receipts in the cash budget, while payroll is an expense in the income budget and a payment in the cash budget.

Both budgets are organized according to products. Thus, the departmental organization will be replaced by a product-oriented structure. This organization is based on a hierarchical product catalog (product areas – product groups – individual products). Products represent a group of interconnected services, thus internal services can be easily distinguished from external services provided to citizens. Internal services are essential to the provision of external services, and this relationship is recognized in internal service charges in the income budget. This product-oriented structure facilitates understanding of issues and priorities by the governing body and senior management during both budget development and budget monitoring.

Developing a balanced annual budget under this new system is accomplished through the income budget. This process is more difficult than before, given that the treatment of expenses requires

the depreciation of all fixed assets. Additionally, accruals for pending claims and for deferred maintenance are included in the budget as expenses. Neither depreciation nor accruals for pending claims are now included in the budget to any meaningful extent. The new regulations increase both these amounts such that expenses in the income budget are much higher than the corresponding payments in the cash-based operating budget. Recognizing that this could lead to substantial deficits in the income budget, legislators included a provision that allows local governments to include one-third of their equity capital in the reserve. The question as to what will happen once this reserve is exhausted remains unanswered.

CONCLUSION

Will this latest development improve the financial condition of German local governments and encourage them to decrease their debt burden? Only time will tell. What is certain is that this new budgeting system offers built-in arguments against adding to the debt burden. This prognosis is supported by several factors. Political decision makers for the first time must ensure that revenues are sufficient to cover the depreciation of fixed assets in the income budget. There is no room for financing new capital projects on credit, as the required interest payments would only increase expenses in the income budget. Beyond the optimistic prospect that the debt burden of German local governments will finally stabilize, there is hope that these same governments will become more entrepreneurial as their accounting and budgeting systems begin to mirror those of private enterprise. In addition to defining a balanced budget as a key-prerequisite for a good performance the new system for the first time establishes a shift from the input-oriented to an output- and outcome-oriented budget.

Transitioning to the new budgeting system will not be without challenges. For starters, staff will have to get used to the new budget categories; the differences between revenues and cash receipts on the one hand and expenses and payments on the other is an adjustment that might take some time. Extensive training will be necessary, and new software will have to be purchased and installed. Whether German local governments can overcome these obstacles and realize significant improvements in their financial management practices remains to be seen.

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EXHIBIT 1: COMPARISON OF GERMAN LOCAL BUDGETING SYSTEMS	
Past - Ordinary Budget (Accrual Basis)	
Revenues: <ul style="list-style-type: none"> ▪ Taxes ▪ Fees ▪ Fines ▪ Rents ▪ Investment income ▪ Grants (for operating expenses) ▪ Grants (for capital projects) ▪ Transfer from special reserves 	Expenses: <ul style="list-style-type: none"> ▪ Operations and maintenance ▪ Payroll ▪ Principal and interest ▪ Transfer to special reserves/balance reserve ▪ Capital outlays
Past – Extraordinary Budget (Accrual Basis)	
Revenues: <ul style="list-style-type: none"> ▪ Debt proceeds ▪ Sales of assets 	Expenses: <ul style="list-style-type: none"> ▪ Capital outlays
Present – Operating Budget (Cash Basis)	
Cash Receipts: <ul style="list-style-type: none"> ▪ Taxes ▪ Fees ▪ Fines ▪ Rents ▪ Investment Income ▪ Grants (for operating expenses) 	Payments: <ul style="list-style-type: none"> ▪ Operations and maintenance ▪ Payroll ▪ Interest ▪ Partial depreciation ▪ Balance to Capital Budget
Present – Capital Budget (Cash Basis)	
Cash Receipts: <ul style="list-style-type: none"> ▪ Balance from Operating Budget ▪ Debt proceeds ▪ Transfer from common reserve ▪ Grants (for capital projects) ▪ Sales of assets 	Payments: <ul style="list-style-type: none"> ▪ Capital outlays ▪ Principal ▪ Transfer to common reserve
Future – Income Budget (Accrual Basis)	
Revenues: <ul style="list-style-type: none"> ▪ Taxes (anticipated tax assessment) ▪ Fees ▪ Fines ▪ Rents ▪ Investment income ▪ Grants (for operating expenses) 	Expenses: <ul style="list-style-type: none"> ▪ Operations and maintenance ▪ Payroll ▪ Interest ▪ Full depreciation ▪ Accruals for pending claims, pension system contributions, etc. ▪ Internal service charges
Future – Cash Budget (Cash Basis)	
Cash Receipts: <ul style="list-style-type: none"> ▪ Taxes (anticipated cash receipts) ▪ Fees ▪ Fines ▪ Rents ▪ Investment income ▪ Grants (for operating expenses) ▪ Debt proceeds ▪ Transfer from common reserve ▪ Grants (for capital projects) ▪ Sales of assets 	Payments: <ul style="list-style-type: none"> ▪ Operations and maintenance ▪ Payroll ▪ Interest ▪ Capital outlays ▪ Principal ▪ Transfer to common reserve

¹ Rudolf Johns, "Gemeindewirtschaft," in: *Handwoerterbuch der Betriebswirtschaft*, 2nd ed. (Stuttgart, 1938).

² Ludwig Muelhaupt, "Die Plaene zur Reform der ordentlichen Haushaltsrechnung," *Der Oeffentliche Haushalt, Archiv für das Oeffentliche Haushaltswesen* 11, no. 2/3 (1970).

³ Juergen Gornas, "Creation and Successful Implementation of a new Budgeting and Accounting System in Germany, with Stress on Electronic Tools," *Public Finance and Management*, 4, no. 2 (2004).