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# Budget Residues Constituting a Budgetary Risk

**SUMMARY:** Nowadays, the quality of fiscal management is increasingly significant. The generation and use of budget appropriation residues is an important, however, hardly analysed topic in either the Hungarian or the international literature. This article outlines the role of appropriation residues in fiscal management, as well as the cases of its generation. It underlines that both the large-scale generation and the use of residues represent budgetary risks. Based on the final accounts data of the period between 2007 and 2016, it analyses the characteristics of the generation and use of the residues of the central budget. It underlines that although the balance of residues generated and used fluctuated in different years, there has been a trend of increase in the value of residues generated and used. Next, the study aims to investigate the reasons behind the generation of residues by analysing individual budget headings. Finally, the article draws attention to the fact that several tools are available for the government (such as the application of “pool technique” or accrual-based accounting) to manage the risks associated with residues.

**KEYWORDS:** central budget, budget deficit, residue generation, the use of residues, public accounting

**JEL CODES:** H30, H50, H61, M41

In the State Audit Office’s audits and in its analyses prepared for the Fiscal Council, it was found that a significant change in appropriations occurred in the implementation of the central budgetary act in each budget year, and that the use of the appropriation residues was significant, when compared to the budget total. Regarding this feature of fiscal management, the manner in which the generation and use of residues may influence the cash balance of the budget, and the extent to which it could represent a risk to its fulfilment are still to be investigated. The study aims to find answers to this question, partly by presenting the theoretical correlations, and partly based on the data of the final accounts of central budgets for the period between 2007–2016.

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The data were collected from the final accounts bills of the years 2007–2016, available to download from the website of the National Assembly. The bills were adopted by the National Assembly without making modifications on the figures, therefore the data used for the analysis correspond to the data of the final accounts acts.

## THE CONCEPT OF APPROPRIATION RESIDUES AND THE REASONS BEHIND THEIR GENERATION

As defined by Act CXCV of 2011 on Public Finances (hereinafter: Public Finance Act), “*residue means the difference between the revenues and expenditures during the fiscal year, classified as budget residue in reference to the revenues and expenditures of the core activity,*

*and as business residue in reference to the revenues and expenditures of business activities.*"<sup>1</sup>

The generation of residues is an inherent feature of cash-based fiscal management. This is because fiscal management applies a one-year period both for planning<sup>2</sup> and for reporting purposes on the execution of the budget, that is to stay for the final accounts. Nevertheless, in the framework of fiscal management, a number of economic events exist that embrace several fiscal years (for example the implementation of an investment), or planned revenues or expenditures are not realised within the given fiscal year due to various reasons. Typical (direct) reasons behind the generation of expenditure appropriation residues include:

- changes in the content of the framework of the performance of public duties,
- an unplanned reduction of the employee headcount at budgetary institutions,
- a more economical performance of public duties,
- deferral of contribution payment obligations to the following year,
- delays in the conclusion of contracts, for example because of the failure of public procurement tenders,
- deferral of the implementation and the financial performance of programmes financed from the budget to the following year,
- revenues exceeding estimates,
- application of compulsory, specific accounting rules regarding a given expenditure item,
- deficiencies of planning,
- prescription of generating mandatory reserves by the supervisory authority.

The Budget Act does not provide financial resources for the fulfilment of public duties, but it allocates expenditure appropriations to the tasks defined in the Act. This is in fact an authorisation given to the addressee (manager) of an appropriation to make commitments

under specific conditions up to the amount of the expenditure appropriation, and then to make payments. However, an expenditure appropriation may only be used in the given fiscal year. If the expenditure appropriation is not used in full in the given fiscal year, an expenditure appropriation residue is generated to the extent of the remaining amount. From a cash-based perspective this is considered to be a saving, given that the amount was not spent. From an economic point of view however, we cannot consider this to be a saving if the commitment has already been made for the appropriation, but not the payment. (For example, some goods have been ordered, but the delivery date is in the following year, therefore, the goods have not yet been delivered and their price has not been paid yet.) This means that in such a case, an expenditure obligation is generated, but its performance will only be due in the following fiscal year, however, the expenditure appropriation is no longer valid for that year.

This problem is overcome by Hungarian fiscal management by allowing the increase of expenditure appropriations of the given year up to the committed part of the expenditure appropriation residues from the previous year. Legally, this is defined as an appropriation amendment. Considering that commitments need to be settled, the appropriation amendments required are not approved by the National Assembly, but by the budgetary institution itself that is concerned or the governing body of the heading.<sup>3</sup> The appropriation hence defined may be used for the fulfilment of obligations until 30 June.

It is less clear however, why it is important to authorise the use of uncommitted expenditure appropriation residues in the following year.

One of the reasons behind this is that a task needs to be performed, but its implementation has not reached the phase of commitment

yet. (For example, in case of a procurement of significant value, a public procurement tender was published, but it had to be declared invalid and as a result the relevant contract not be signed.) In this context, it would lead to the failure of the task if the use of the residue of the expenditure appropriation was not authorised.

In another scenario, the addressee of an appropriation had resolved the task in a way that had been more economical than planned, therefore, the use of the whole appropriation was not required. In such a case, it is reasonable to allow the part of the appropriation saved to be used for another important purpose by incentives. These cases however, require further consideration. Therefore, it is the duty of the government to decide on the use of uncommitted appropriation residues, based on the proposition of the minister in charge of public finances.

There is a third example for the use of uncommitted appropriation residues, namely when the government reallocates appropriation residues, and enables their use for other purposes. The legal explanation behind this is that spending the money has already been approved by the National Assembly, and as a consequence, the government responsible for the execution of the budget may spend it. The legal possibility for spending residues for purposes other than the plan provides the government with more room for manoeuvre to authorise unplanned budget expenditures during the year that have not been previously approved by the National Assembly. From a fiscal management perspective, an uncommitted residue serves as a budget reserve that may be freely spent by the government. From an economic point of view this may not be a problem if the budget of the previous year has a positive balance, because in such a case, a residue exists that may actually be spent up to the value of the surplus. In case of a budget

deficit however, we cannot talk of a residue that may actually be used.

The increase of an expenditure appropriation by adjustment generates spending that is not covered in the budget of the given year. (The coverage of budget expenditures of the given year is defined as the budget revenues of the given year and the deficit defined in the Budget Act.) Hungarian budget legislation gets round this problem by using the term financing revenues for the residues to be used through the amendment of the appropriation.<sup>4</sup> This is therefore not an actual revenue, only an authorisation given to the Hungarian State Treasury to finance expenditures up to the extent of appropriation adjustments. Considering that the balance of the budget was negative in each year of the period examined, no actually usable residues were generated in the budget as a whole. Therefore, the use of residue appropriations generated in the previous years increased the budget deficit in the year of use. In this context, the authorisation of the use of residues in the form of appropriation adjustments is (was) nothing else than an authorisation to increase cash deficit.

If this reasoning is correct, how is it possible that the budget deficit does not exceed the value allowed by the Budget Act each year? Amongst others, it is because the use of appropriation residues has a real coverage as well: the residues generated in the given year reducing the cash deficit in the given year. The generation of residues and their use in the following year is a constant feature of fiscal management. The risk, however, is that the generation and use of residues is not uniform in individual years, which may jeopardize the fulfilment of the targeted budget balance in the year when the generation of residues is lower in amount as compared to the use of the residues generated in the previous years. The analysis quantifies this risk, presenting it in relation to the budgets of 2007–2016.

## GENERATION AND USE OF RESIDUES BETWEEN 2007 AND 2016

Hereinafter, we will analyse the central budget, forming a part of the central subsystem of public finances, given that the generation of residues is not characteristic of social security funds and of separated state funds due to their fund-based financial management. (Residues are only reported by the budgetary institutions financed from those funds.)

First of all, we should review the amount of residues generated each year during the past 10 years, the evolution of the use of the residues of the previous years and the difference of the two. This is demonstrated in *Table 1*.

By examining the second and third columns of the table it can be concluded that the residues generated show an increasing tendency, and the value of the residues that were

used also increased, even if at a lower rate than their generation. The increase of the amount of the residues is partly explained by the fact that the total of expenditure appropriations of the budget also increased in the period examined. Its rate of increase, however, was lower than the dynamics of residue generation. This correlation is described in the last column of *Table 1*, given that panel data indicate that the amount of the residues generated increased from 3.92 percent in 2007 to 16.72 percent of the total expenditures in 2016. However, the increase was not consistent; high peaks can be found in 2008, 2014 and 2016, while in the years in between, the ratio of the residues generated sometimes decreased and sometimes increased as compared to total expenditures. The reasons behind the peaks and fluctuations are analysed in latter chapters of our study based on justification and data on a

*Table 1*

### CHARACTERISTICS OF THE GENERATION AND USE OF RESIDUES IN THE SUBJECT YEAR BETWEEN 2007 AND 2016

Years	Residues			
	generated in the subject year	their use	the difference of their generation and use	generated as a percentage of the total expenditure
	HUF billion			percent
2007	333.1	356.5	-23.4	3.9
2008	526.0	342.7	183.3	5.8
2009	484.5	459.2	25.2	5.3
2010	532.5	540.6	-8.1	5.7
2011	557.9	575.8	-17.8	5.5
2012	637.6	528.5	109.0	6.4
2013	695.7	633.2	60.6	5.8
2014	1332.7	961.2	371.5	10.4
2015	1140.8	1344.1	-203.3	8.7
2016	2211.2	1140.1	1071.1	16.7

Source: Own editing based on the data of final accounts bills

heading level. (In the justifications of the final accounts bill, the government presents the use and generation of residues at the level of the entire budget and in a breakdown by headings/titles. In certain cases, the figures are supplemented with textual information where, sometimes, the reasons behind residue generation are presented in detail.)

Beforehand, however, we will try to find out more about the correlation between the differences of the generation and use of residues, and the deficit of the central subsystem of the budget in the period examined. The summary of the data required for this purpose is presented in *Table 2*.

Table 2 indicates that the difference between the actual balance of the budget and the balance as defined by the Act, as well as the difference between the use and generation of residues (residue balance) show the same

trend, except for two years (2007 and 2009). In 2008 for example, the balance was better than planned with a surplus of HUF billion 247.4, and HUF billion 183.3 less residues were used than generated. This “saving” reduced the deficit, therefore, it contributed to reaching a deficit significantly lower than the level prescribed by the Act. In 2015, however, the use of residues exceeded their generation by more than HUF billion 200, so the deficit was HUF billion 400 higher than the estimates.

By comparing line three and four of the table it can be seen that the difference of the balance as defined by the Act and of the actual balance is explained to a rather variable extent only by the difference between the generation and use of residues in each year. For example, the difference of residues added 11 percent to the deterioration of the budget balance

Table 2

**THE CORRELATION OF THE DEVIATION OF THE BUDGET BALANCE FROM THE PLAN AND OF THE GENERATION AND USE OF RESIDUES (2007–2016)**

Year	Balance as defined by the Budget Act	Fulfilled/actual balance	Difference of the balance as defined by the Act and the actual balance (1–2)	Difference of the generation and use of residues in the subject year
(HUF billion)				
2007	-1656.5	-1398.2	258.3	-23.4
2008	-1117.7	-870.0	240.7	183.3
2009	-675.9	-743.7	-67.8	25.2
2010	-830.0	-889.5	-59.5	-8.1
2011	-1531.0	-1741.6	-196.1	-17.8
2012	-689.5	-598.6	78.3	109.0
2013	-1117.8	-932.8	210.6	60.6
2014	-1126.8	-803.0	110.4	371.5
2015	-835.6	-1237.2	-323.5	-203.3
2016	-751.1	-825.0	73.9	1071.1

Source: Own editing based on the data of the final accounts bill

in 2011, whereas the ratio was 59 percent in 2015. On the other hand, 31 percent of the balance improvement was due to a surplus of the residues generated as compared to those used in 2013. As a result, the figures also underline that the difference between the generation and use of residues is an important, but not the only reason of the deviation of the balance as defined by the Act and of the actual balance. Another important reason is the different evolution of the revenues as compared to the plans, as well as exceeding certain expenditure appropriations for the subject year.

### GENERATION AND USE OF BUDGET RESIDUES, IN A BREAKDOWN BY BUDGET HEADINGS (2011–2016)

In order to identify and come to a thorough understanding of the risks present in the overall

budget, it is advised to examine the process of the generation and use of residues in a budget heading breakdown as well, especially because the authorisation of the use of residues, that is to say, the modification of the appropriation is performed mostly on a heading level.

Our analysis covers the period between 2011–2016 and the Ministry headings, as well as the heading termed EU developments. Around 85–90 percent of budget residues are generated under these headings (see the last row of *Table 3*), and the change of the aggregated residues of the eight headings was convergent with the figures of the central budget in each year. Consequently, the aggregate evolution of the residues of the eight headings is rather close to the evolution of the residues in the central budget.

It can be seen that the evolution of the balance of residues is extremely fluctuating between the different headings, both in terms of

Table 3

#### BALANCE OF THE GENERATION AND USE OF RESIDUES IN THE SUBJECT YEAR FOR EACH HEADING (2011–2016)

Number and name of the heading	2011	2012	2013	2014	2015	2016
	(HUF billion)					
XI. Prime Minister's Office	1.4	-0.3	17.4	-22.6	3.3	203.4
XII. Ministry of Rural Development/Agriculture	-17.6	13.9	26.3	30.3	-16.6	8.9
XIII. Ministry of Defence	-0.7	-15.2	-4.5	0.3	5.8	6.3
XIV. Ministry of Interior	0.7	3.1	3.1	6.8	31.1	149.3
XV. Ministry for National Economy	-45.3	10.5	4.4	0.1	15.7	72.5
XVII. Ministry of National Development	3.2	-14.5	-4.1	-10.1	133.9	-66.1
XIX. EU developments	8.0	77.2	-41.3	247.4	-361.5	270.5
XX. Ministry of Human Capacities	0.4	18.5	52.4	88.1	-14.3	395.7
Total of the chapters above	-49.9	93.1	47.5	340.2	-209.2	1040.5
Total of the central budget	-17.8	109.0	60.6	371.5	-203.3	1071.1
Total of the eight headings as a percentage of the total of the central budget	61	85	78	92	97	97

Source: Author's own editing based on final accounts bills

their direction and amount. The fluctuation is natural, because if more residues are generated in a given year than the residues used, the residues accumulated must be eliminated in the following years. Extreme fluctuation, however, increases budget risks, considering that the use of the residues under a given heading may deteriorate the cash balance of the budget by tens of billions of HUF. This was the case for example at the Ministry for National Economy in 2011. Another risk-increasing factor is that the generation of residues with several headings exceeded their use for a period of 4–6 years, as result of which major residues accumulated with them.

From the perspective of residues, the heading EU developments needs to be examined separately, considering that the highest amount of residues had been accumulated under this heading until 2014 which were then used within one year in 2015, deteriorating the cash balance of the budget by HUF billion 361.5. The fact that the use of and accounting for the EU funds awarded in a given year was often carried over to the following year played an important part in residue generation under this heading. Nevertheless, all EU funds had to be used by the end of 2015, as a result of which all residues that had been accumulated were spent, while there were almost no items carried over.

2016 was a peak year from the perspective of the generation and use of residues. Large-scale residue generation is mostly associated with EU development projects. On the one hand, technically, there were no EU residues available at the end of 2015, so there was nothing to be spent in 2016. On the other hand, new EU programmes made a dynamic start, and advance payments were disbursed to the winners of the tenders. In 2016, 84 percent of disbursements were made as subsidies or supplier advances.<sup>5</sup> However, the advances paid were only used to a minor extent. As a

consequence, an important part of the advances paid to central budgetary institutions entitled to the funds was considered as residues by these entities. This is reflected in the data of the table, because the balance of the generation and use of residues exceeded HUF billion 100 in the case of three Ministry headings in 2016. The residue balance exceeding HUF billion 1000 at central budget level was an important contribution, so the cash balance of the central budget was more favourable than planned.

Beside the evolution of the absolute amount of residue balances generated with each heading, it is advised to examine the relative changes of residue balances as compared to the total expenditures of the heading, because it indicates to what extent the fluctuation of residue balances influenced the financial management of each heading. The residue balances of each heading are presented in *Table 4* in comparison with their actual expenditures.

The data of eight headings over six years, that is to say, a total of 48 pieces of data indicate that the absolute value of the residue balance did not reach 5 percent of the actual expenditures in 27 cases, it was between 5 to 10 percent in 8 cases and exceeded 10 percent in 13 cases. Prominently high values were quantified in five out of the latter cases, exceeding one third of actual expenditures. It is noteworthy that the residue balance exceeded 10 percent of actual expenditures with 5 headings in 2016, which underlines that 2016 was a critical year from the point of view of residue generation.

By examining the differences between the headings, we can note that the evolution of residue balances was the least volatile in the case of the Ministry of Defence. Except for one year, rather low volatility characterised the Ministry of Interior and the Ministry of Human Capacities. One outlier can be found in the case of the Ministry of Rural Develop-

Table 4

**BALANCE OF THE GENERATION AND USE OF RESIDUES IN THE SUBJECT YEAR AS COMPARED TO THE EXPENDITURES OF EACH HEADING (2011–2016)**

Number and name of the heading	2011	2012	2013	2014	2015	2016
	(percent)					
XI. Prime Minister's Office	107.7	-2.1	63.5	-6.2	-1.0	49.1
XII. Ministry of Rural Development/Agriculture	-3.3	3.3	-6.2	-12.4	6.0	3.3
XIII. Ministry of Defence	-0.3	-5.7	-1.7	0.1	2.3	1.8
XIV. Ministry of Interior	0.2	0.6	-0.5	1.1	3.7	16.3
XV. Ministry for National Economy	-36.9	14.8	3.1	0.0	7.6	22.7
XVII. Ministry of National Development	0.6	-4.0	-1.2	-3.0	36.9	-7.7
XIX. EU developments	0.7	6.6	-5.0	10.9	-12.5	13.0
XX. Ministry of Human Capacities	0.0	1.3	2.3	3.5	-0.5	14.0

Source: Author's own editing based on documents on the final accounts

ment/Agriculture and the Ministry of National Development. In the case of the Prime Minister's Office and the Ministry for National Economy headings, the residue balance was extremely fluctuating in the period examined. In general, outliers can be explained by reasons associated with changes in the structure of the budget (for example, dissolution of budgetary institutions and accounting for their residues, creation of new institutions that only reached their planned capacity gradually). Residues increased in the cases when a government decree passed at the end of the year reallocated significant amounts to certain Ministries which were no longer capable of spending the appropriation during the year. In other cases, the start of new aid schemes was delayed and resulted in the generation of residues of large amounts.

Under the EU development chapter, the absolute value of residue balances exceeded 10 percent between 2014–2016, but it was not outstandingly high in the previous years. This indicates that the transitional accounting of EU development funds between different years influences significantly the evolution of

the cash balance of the central budget first of all by the size of the amounts involved. However, the main reason behind the significant residue generation in 2016 is that the beneficiaries could not spend a significant part of the amounts received as an advance for the programmes implemented with EU support during the year.

Based on Table 4, the residue balance decreased in 18, and increased in 28 out of 48 cases (and did not change in two cases). This also underlines that residue levels show an increasing tendency, as a consequence, accumulated residues carry a growing potential risk with regards to the cash balance of the following years.

**MEANS TO MANAGE THE RISKS ASSOCIATED WITH THE GENERATION AND USE OF RESIDUES**

The government has different means to manage the risks (as presented earlier) associated with the generation and use of residues. The most fundamental among them is the application of



monitoring tools to track the actual fulfilment of the appropriations and to estimate their expected fulfilment. As part of that, it would be justified to pay attention to the evolution of the sum of the committed residues carried over from the previous year, considering that most of them will be used in the subject year which is an unplanned expenditure in the budget. Similarly, it is useful to carry out regular audits from the end of the first half year to find out about the expected amount of residues to be generated in the given year.

Another instrument is the use of uncommitted residues or their postponement or non-use. As we have underlined it beforehand, uncommitted residues are some kind of a budget reserve, therefore, it should be carefully considered before making the relevant decision whether the expected evolution of the budget balance allows for the large-scale use of uncommitted residues or whether it is advised to abandon such plans in order to make sure that the target deficit can be sustained.

Handling uncommitted residues as reserves is reflected in the idea of the government, which intends uncommitted budget residues of budgetary institutions belonging to the central subsystem of public finances and of chapter-managed appropriations to be paid, after the acceptance of the budget report, to a central residue accounting appropriation yet to be created. This solution would make the evaluation of how much uncommitted residues were generated in total in the central subsystem of public finances more transparent. This would make it easier for the government to manage this appropriation, namely, to use it in greater proportions if the balance of the budget is more favourable than planned, or to renounce its use if it is required in order to maintain the target deficit.

The third instrument is the so-called “residue retention” requirement, which is used by the government to bind the budget headings

under its control to generate at least as much residues in a given fiscal year as the level of residues they used from the previous year. In other words, it applies a direct requirement to prevent the negative balance of the generation and use of residues deteriorating the overall balance of the budget. This intervention, however, has negative effects as well, given that the financial management of budgetary institutions should be subordinated to an artificial requirement in that way. For example, a significant residue of the previous year may have been caused by the deferral of the financial fulfilment of a procurement of a larger amount to the subject year. However, if no such significant procurements take place in the subject year, the budgetary institution can only fulfil its residue retention obligation if it delays ordering numerous small procurements until the end of the year and transfers their financial fulfilment to the following year. Delays in procurements, however, may cause operational problems, and late payment of the invoices may cause liquidity issues for suppliers. In order to avoid this type of difficulties, it is advised to impose residue retention obligation on a heading level, because this way, the head of the governing body of the heading has the possibility to differentiate residue retention between the budgetary institutions and the chapter-managed appropriations in a way so that it should cause the least possible difficulty in financial management.

The State Audit Office of Hungary published its report on the audit called “The audit of equilibrium improving measures – the audit of certain equilibrium improving measures and their impact on the execution of the budget” in February 2015. The audit covered the period between 1 January 2007 and 31 September 2013. The report stated that during this period, residue retention obligations were imposed in 2007, 2009 and 2011, which

were fulfilled or even exceeded every year. The impact of residue retention obligations on the operation of institutions and on the exercise of functions was audited at 15 randomly chosen institutions. The audit found that residue retention did not cause a delay in exercising their functions and no tasks remained unfulfilled in the case of the sample institutions (affected by residue retention), but financial management possibilities were less diverse and planning the tasks was affected in a negative way. In terms of operations, unpaid invoices also caused delays, which was pointed out by two institutions in connection with the appropriations of procurements and maintenance activities associated with facility management of the institutions. These tasks were completed in the following year by using the residues carried forward.<sup>6</sup>

From the perspective of financial management of budgetary institutions, it is even more critical if the government reciprocates the large-scale use of residues from the previous year (and other processes increasing the budget deficit) by freezing or cutting back the appropriations for the subject year, since in such a case the implementation of the expenditures planned for the given year should be renounced. It is clear that the later a freezing (cut-back) is ordered, the more difficult it is to resolve the resulting operational and financial management issues.

The impact of freezing on the operation of institutions and on the exercise of functions was audited by the State Audit Office of Hungary at 15 randomly chosen institutions. It concluded that the institutions fulfilled their freezing obligations. However, *“50 percent of the audited organisations pointed out that due to the freezing, certain procurements were cancelled, 10 percent of them resolved the problem of cancelled procurements in the following year by using the residues transferred from the previous year.”*<sup>7</sup> 20 percent of the institutions pointed

out that they had to deal with unpaid invoices due to the freezing, but they were could not specify either the number or the amount of such invoices.

Despite the negative impacts presented, so called mid-year balance improvement measures were taken by the government in each year between 2011 and 2014. In February 2011, the government made a decision in Government Decree no 1025/2011. (II. 11.) on the measures required to maintain the budget balance. This included saving measures of around HUF billion 250. The government introduced another balance improvement measure of HUF billion 100 in total in September 2011, imposing amongst others, a ban on asset procurement and freezing expenditure appropriations up to HUF billion 37.0. Besides all the above, the government ordered a residue retention obligation of HUF billion 577 in its decree 1316/2011. (IX. 19.), which was lifted late December in Decree 1505/2011. (XII. 29.) in order to reduce outstanding debts.

In 2012, HUF billion 48.8 were frozen or reduced in total. All that affected central budgetary institutions and chapter-managed appropriations, the general reserves serving as a coverage for extraordinary government measures, and the PPP and EU Co-Financing Fund appropriations. The prescription of residue retention obligation relating to certain expenditure appropriations constituted another balance improvement measure.

In 2013, similarly to 2014, expenditure appropriations were frozen or reduced in the amount of HUF billion 93. The freezing or reduction affected budgetary institutions and budget headings as well.

In 2014, the government decisions on freezing expenditure appropriations and their rescheduling for later periods amounted to HUF billion 110 in total. In the second half of the year, when favourable evolutions of the

balance were already visible, the freezing was lifted.

In 2015 and 2016, no mid-year restrictive measures were taken because it was possible to reach the target deficit without them. In order to do so, besides the favourable evolution of revenues, the Budget Act contained a multi-element reserve system which provided the government with sufficient room for manoeuvre to perform the required interventions without taking mid-year measures. Adequate budget reserves do not only provide coverage for extraordinary expenditures or revenues failing to not reaching target, but also for overcoming the difference between generated and used residues, if they are not too large. Consequently, an important way of risk management is to reduce the generation of residues to the required minimum.

There are several options to reduce residue generation. In order to explore these options, it is advised to investigate the reasons behind residue generation and examine the possibilities which could help to reduce their impact. This article will highlight one that is the most promising.

One of the fundamental reasons behind residue generation is that programmes, procurements of the subject year and their financial fulfilment are carried over to the following year. The level of payments carried over for the following year may be reduced significantly if the preparations of the programmes and procurements are started already in the year before the subject year. A favourable condition to do so is that the National Assembly approves the budget of the following year already in the first half year, which makes it possible to start the preparation of the spending of approved expenditure appropriations (for example preparation and announcement of tenders, calls for public procurement).

Another option to reduce the amount that is carried over is by not planning the cover-

age of the implementation of programmes extended over several years into the budget of the given year, but dividing it between several years. Of course, this is applied currently as well. Still, there is an intention by the headings to arrange for budget coverage of a programme in the budget of the given year that is unlikely to be implemented within one year. The reason behind is that the coverage of a programme is considered to be safe if it appears in the budget of the given year, hence, it enjoys legislative guarantee. This comprehensible effort may be made unnecessary, if currently prepared three-year long budget framework adopted by a government decree contained the appropriations for the several-year long programmes adopted in the given year item by item for the following years, and could adequately guarantee that the appropriations fixed in the master plan are adopted in the budget of the following years. For example, within the mid-term master plan, the appropriations covering several-year long programmes could be defined by the government by making a compulsory integration of the appropriations into the budget appropriation bills of the relevant years.

The risk of using an appropriation carried over to the following year is highest in case of large value investments, because in case of such an operation there is a high danger that the problems of the preparatory phase (for example expropriations, supplementary tasks required for environmental protection, archeologic excavations), or delays in public procurement procedures may postpone the start of the investment project as compared to the planned date. To reduce the risks, larger investment project can be handled as “pools”,<sup>8</sup> which means that a budgetary appropriation for the subject year is defined for several investment projects together. In such a case a delayed start of given investments may be compensated by accelerating the im-

plementation of other investment projects which may be re-compensated during the following years. Although the Investment Fund had been created for a different purpose in the Hungarian budget, it was still suitable for a partial management of time-related risks of the investments. This is underlined by the fact that in 2016, HUF billion 50 out of the HUF billion 150 expenditures of the Fund were not used as in the original appropriation, based on the decision of the Minister of the National Economy (The Minister was authorised by the Act on the Budget to reallocate financial resources). It is advised to continue this practice.

## REDEFINITION OF THE CONCEPT OF BUDGET RESIDUES

It is advised to redefine the concept of budget residues as well. Appropriation residues generated with budgetary institutions, following the screening of deferral effects - may be considered as a result of financial management given that it indicates that the organisation fulfilled its tasks with a lower rate of expenditures and/or more revenues as compared to the plan. The residues hence generated are considered long-term savings on the level of public finances, decreasing public debt, that is to say, promoting the fulfilment of the obligation prescribed by the Fundamental Law to reduce the public debt indicator. This definition of residue suggests the scalability of task performance of the budgetary institutions, since this is the only way to determine whether budget residues were generated due to the task being carried over, cancelled or as a result of effective financial management.

In order to evaluate the economic content of cash flow residues, it is especially useful that accrual-based financial analysis should also be

made in public finances accounting besides the traditional cash-based approach (budget accounting). (Simon, 2012). In accrual-based accounting, the impacts carried over from year to year are considered as deferred or accrued time-based accounts, therefore it can be determined quite accurately whether a financial saving at the end of the year should be considered to be a real profit or whether it only reflects the year-to-year difference between revenues and expenditures (Harsányi et al., 2016). Similarly, it is determined by accrual-based accounting an obligation and not as a profit, if residues have been generated because of the non-payment of invoices falling due or because of a failure to replenish depreciation. Consequently, the real content of residues generated in a cash-based approach could be qualified with the help of accrual-based financial accounting only. The budgetary institutions and headings achieving real savings could be rewarded as a result of this rating, for example by leaving a part of uncommitted residues at their disposal.

Based on the above, the most drastic tool for the elimination of the risks associated with residues would be the application of an accrual-based accounting methodology instead of the cash-based one. By using this methodology, the disadvantages of cash-based fiscal management may typically be eliminated, including the risks associated with residues as presented in this study.

The reason behind this is that the accrual-based method differentiates between expenditure and costs as well as between revenue and profit as accounting categories. The accrual-based approach records all transactions in connection with financial management, clearing them in the accounts in line with their content. In line with accrual-based accounting, the main criterion to be considered is not the fact whether a given transaction has been realised from a financial perspective but

the fiscal year it is associated with. This way, an expenditure item not spent in a given year from a cash-based point of view (residue) is cleared in the accounts as a cost in the appropriate fiscal year based on an accrual-based logic. This way, the clearing of residues generated in the budget does not create an obstacle to the clarity of budgetary processes. As a consequence, the budgetary processes of the given year may be unambiguously measured, and the characteristics of their fulfilment can be presented.

Nevertheless, accrual-based accounting may not be considered to be a “magic wand” in itself. Based on international experience, the application of this methodology may only be successful if it is applied simultaneously in different fields of fiscal management. One of these is budget planning, the follow-up of implementation and the preparation of reports on budget processes.

If for example, the accrual-based method was only applied during report-making, it would be required to apply complicated and complex methods to consolidate various cash-flow type data which is costly and carries the risk of errors.

Moreover, it would not be ideal either to apply the accrual-based methodology at the level of budgetary institutions only. In this case, annual budget reports would not be able to present the financial management characteristics of the budget applying cash-based revenue and expenditure categories. This way, several important data would be omitted from the presentation (typically information on asset management and profitability) which would be of utmost importance in order to perceive the quality of financial management, and to plan the budget of the following years.

In case of fiscal management, not only the financial but also the asset factors, and in many cases profitability criteria may be applicable and are at least as important as planning

and spending revenues and expenditures. The actual accounting and the associated reporting practice of residues draws special attention to these features of fiscal management. The application of an accrual-based approach may contribute to a wider understanding of various aspects of financial management, and may provide a basis for certain financial management decisions. Nevertheless, based on international experience, the generation of more information on a wider scale compared to their current level requires an increase of the budget expenditures translated into public accounting.

## CONCLUSIONS

In our article we described that the generation of end-of-year residues and the use of their committed part in the following year is a characteristic feature of cash-based fiscal management. The generation and use of residues however takes place to different extents in various years. If the amount of used residues exceeds that of the residues generated, the cash balance of the budget will deteriorate. As a consequence, two budget risks have been identified. First, the use of residues in a given year exceeds the value of generated residues, increasing the deficit in this way. Second, a rather significant amount of residues are accumulated over the years, the quick use of which would severely jeopardise the fulfilment of the target deficit of the budget in the given year.

Based on the Hungarian final accounts data between 2007–2016 we have shown that these risks exist in practice as well, and regarding their tendencies, a close relationship can be perceived between the balance of the central budget and the evolution of the balance of residues. The risk is even higher due to the fact that in the case of certain headings in certain

years, the change of the balance of residues was outstandingly high as compared to the total expenditures of the heading.

The government has several means to manage the risks associated with residues. A part of them have been regularly used by the government, but there are further risk mitigation

tools available that we have also presented in the article. For the definitive dissolution of the risks associated with residues, Hungarian public accounting should become completely accrual-based. Until then, it would be advised to assess the residues generated using accrual-based financial analysis.

## NOTES

<sup>1</sup> Article 1(17) of the Public Finance Act

<sup>2</sup> The three-year planning methodology as defined in Article 24(4), Section d) of the Public Finance Act is not relevant with regards to our topic, because it is the processes of the annual budget that are presented in the framework of the final accounts.

<sup>3</sup> The general rules alone are presented here, while the detailed regulations are defined by Article 86 of the Public Finance Act and Articles 149–155 of the Decree on the Implementation of the Public Finance Act. The detailed regulations on the use of residues were continuously changing during the

examined period as well. This is also why we do not aim to make a detailed presentation on the legal framework.

<sup>4</sup> Article 6(7), Section ac) of the Public Finance Act.

<sup>5</sup> State Audit Office of Hungary (2017/a), page 26

<sup>6</sup> State Audit Office of Hungary (2015), page 45–46

<sup>7</sup> State Audit Office of Hungary (2015), page 50

<sup>8</sup> Pool is a well known, established and cheap tool for risk management in a lot of other areas of business.

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