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RATIONALITY AS A BASIC CONDITION FOR PUBLIC FINANCE REFORM

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Abstract

Rationality of public finance is impossible without a clear model concept of the state, its role and consequent scope of public tasks realized (main research hypothesis). Unfortunately, due to the lack of an unambiguously accepted and consistently implemented vision of the state, both the socio-economic shifts and the attempts to reform the public finance sector throughout the transformation process in Poland have been characterized by a far-reaching lack of cohesion – governments and parliaments have changed, political doctrines have changed, individual manifestos have turned out to contain internal contradictions. And although there has been a constant element of rationalizing public spending, and improving the state's finances, the actions taken have turned out to be rather ineffective, and any results they do have are temporary and illusory, usually subordinated to current economic and political aims (supplementary hypothesis). The aim of this article is to analyze the nature and selected aspects of rationality in public finance, taking into consideration the structural, procedural and stream levels of reforms carried out in the Polish public finance system. It will concentrate on an attempt to answer the question of whether making efforts at reform have effectively realized the requirements for the rationality of public finance.

Keywords

Rationality; public finance; public finance sector; public funds; public expenditure

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1 Introduction

The requirement for rationality has inspired and continues to inspire efforts at reform with regard to the management of public finance. It should be noted that rationality of public finance is impossible without a clear model concept of the state, its role and consequent scope of public tasks realized (main research hypothesis). public finance is, after all, an instrument for executing public authority, and reforming them does not achieve the intended rationalizing effect if they are not properly correlated with socio-economic intentions. Rationality of public finance is thus inherently connected with a clearly articulated and realized a vision of the state. Unfortunately, due to the lack of an unambiguously accepted and consistently implemented model of the state, both the socio-economic shifts and the attempts to reform the public finance sector throughout the transformation process in Poland have been characterized by a far-reaching lack of cohesion – governments and parliaments have changed, political doctrines have changed, individual manifestos have turned out to contain internal contradictions. And although there has been a constant element of rationalizing public spending, and improving the state's finances, the actions taken have turned out to be rather ineffective, and any results they do have are temporary and illusory, usually subordinated to current economic and political aims (supplementary hypothesis).

The aim of this article is to analyze the nature and selected aspects of rationality in public finance, taking into consideration the structural, procedural and stream levels of reforms carried out in the Polish public finance system. It will concentrate on an attempt to answer the question of whether making efforts at reform have effectively realized the requirements for the rationality of public finance. The research hypotheses indicated above have been subordinated to this problem, as has the research method used, which covers analytical and conceptual studies. The inspiration to tackle this question came, among other sources, from publications by C. Kosikowski (2004, 2011), S. Owsiak (2005) and A. Pomorska (2002), as well as by J.M. Buchanan (1997), J.M. Buchanan and R.A. Musgrave (2005) and V. Smith (2013). The article constitutes a continuation of research conducted over many years by the same Author into the system of public finance, the need for and directions of its rationalization.

2 Essence of Rationality

Rationality means basing actions on scientific motives or principles – a rational action is a wise, judicious action which is in accordance with the knowledge one possesses (Latin *ratio* – mind, *rationalis* – rational) (Słownik wyrazów obcych, 1980: 621-622). In psychology, rationality is connected with actions taken purposefully, as opposed to impulsive or reflexive actions. The sociological approach assumes that a rational entity is guided by the hierarchy of values or preferences espoused by a given social community (Pypeć, 2004: 17). Finally, from an economic point of view rationality is considered in the context of the realization of the defined goals of an action by the managing entity. Rationality of management means human activity consistent with the state of knowledge of the surrounding reality, enabling the best social and economic results to be achieved (Owsiak, 1983: 13). Rationality of management is inextricably linked with effectiveness. Effectiveness is a narrower concept, in the economic sense it takes into account the balance of efforts and results, and not all of these, and not in every situation, can be measured and expressed in monetary terms. This is particularly important in the context of managing public funds – indeed, they are allocated not so much for a direct economic effect as for the public good (interest). Rationality thus means not just effectiveness, but also the social justice aspect (Wilkin, 1997).

In the economic sense, two models of rationality can be differentiated – instrumental rationalization understood as striving to increase the extent of activity while simultaneously improving its effectiveness, and teleological rationality, which is expanded to cover the judicious shaping of goals (Leśkiewicz, 1994: 58). The first model concerns the optimum breakdown of available funds for realizing a defined goal, in light of the subject's knowledge. The second model involves ensuring that actions are consistent with the existing regulations and recognized standards, which is crucial with regard to public finance. The supply of public money is, by definition, limited (there are limits to both taxation and public debt), so public spending must therefore also be limited. Rationality of public finance is thus not expressed exclusively in the size of public spending, as this parameter does not provide an adequate basis to assess activity financed from public funds, particularly in the context of the better adaptation of the extent and standard (quality) of this activity to the needs of a given community. This rationality is more likely to lead to an evaluation and choice of goals, and to the formation of a structure of public spending allocated to achieving those goals.

Rationality of public finance can be considered at both the macro- and microeconomic level. The macroeconomic view of rationality refers to the appropriate division of public funds and means both the appropriate level of state income and expenditure (particularly in relation to GDP) and their optimal internal structure. The macroeconomic approach is thus related to the problem choosing which goals and tasks are to be financed from public funds. Hence the most important criterion for rationalizing public finance becomes that of effectiveness (rationalization of choices). Macroeconomic rationality of public spending, and therefore of the entire system of public finance, is relative in nature. It can be considered in the context of the funds necessary to realize public tasks. First, though, the appropriate scope and size of those tasks should be established, and only then the expenditure (understood as the involvement of defined financial resources) for their realization, not the other way round. This is the only way to justify the creation and financing of a non-balanced budget.

The microeconomic approach, on the other hand, concerns rationalization at the level of public sector entities and institutions directly involved in the process of collecting and spending public funds. In particular, this involves showing which organizational/legal forms are conducive to rational management of public money and to the optimal adaptation of resources to tasks. The basic criterion for rationalization understood in this way is effectiveness, particularly in the context of seeking savings in expenditure while achieving comparable effects. Here it should be noted that a full tally of expenditure and effects entails many practical difficulties – to the extent that expenditure is stipulated in the budget and financial plans of entities, the effects are usually difficult or indeed impossible to measure, and often with a significant delay (Owsiak, 1983: 206).

These two approaches, the macro- and micro-economic, are closely connected and mutually conditioned. It is difficult to speak of the rationality of financing individual entities and units of the public finance sector without simultaneously ensuring the rationality of the division of resources for particular areas and tasks. Success can only be achieved if these are treated together. It is worth noting that financial doctrine is dominated more by the macroeconomic approach, which shows the context and consequences of political choices (Buchanan, 1997; Buchanan, Musgrave, 2005). In practice, however, the most commonly occurring requirements are on the micro-economic scale, concerning the financial management of specific public institutions, but their isolated nature does not, unfortunately, guarantee rationality on a macro, systemic scale.

3 Rationality in Light of the Principles of Public Finance

Rationality of public finance is often displayed in the form of theoretical recommendations referred to habitually as financial principles, which essentially constitute recommended requirements or templates of learning, aimed at practical application, elaborated on the basis of previous experience. These firstly and most broadly covered the system for collecting public impositions, creating a catalog of fiscal principles (Gomułowicz, 2001), and budget management, thus creating a catalog of budgetary principles. Budgetary principles have been developed, and indeed still are, in European financial thinking[2], in particular, French, German and Polish. Less importance is ascribed to these in the English-speaking world, including the USA, where rationality of managing public money is connected more with a certain degree of flexibility of action, as well as with the greatest possible optimization of choices made (Musgrave, Musgrave, 1976: 7; Gajl, 1993: 90-91; Szołno-Koguc, 2009: 25). It is worth stressing the significant diversity of views with regard to both the essence and nature of budgetary principles and their content. It is not unusual for the doctrine to stress that it is only the ideas from which the principles stem that remain relatively constant, while their specific development has been and continues to be subject to modifications during particular periods of development of budget management. The content of the principles changes depending on the circumstances, place and time, as well as the opinions of individual Authors writing about the budget and budget system, as they represent different schools of economic and legal thought.

The literature contains many catalogs of budgetary principles, often with no overlap between them. It is worth noting, though, that when examined more deeply this lack of cohesion often turns out to be purely superficial, with analogous ideas given different names (Kosikowski, 2004: 32). Catalogs of budgetary principles also vary considerably in terms of the number and also nature of values identified. Many of the principles they postulate can apply not only to the budget and budget management but to the state's entire political, social or economic system, as every action should involve following normative rules of legality and reliability. The principles of clarity, economy, precision, and realism, which are also widely applied in various enterprises, should apply to every effective effort.

The catalog of most commonly formulated budgetary principles per se should include the principles of universality, unity, specificity (including the principle of specialization), annuality, balance, antecedence, openness, transparency, reliability, and feasibility (Szołno-Koguc, 2007: 27; Szołno-Koguc, 2005: 129-144).

Due to the distinct evolution of opinions on the doctrines of finance and financial law towards a global and comprehensive treatment of public financial management, attempts are increasingly being made to develop the traditional budgetary principles into general rules applying to the public finance system as a whole (Pomorska, 2002: 6). Among the many postulates currently emerging, particularly noteworthy on the road towards rationality are benchmarks applying to the following areas – organization of the public financing sector (structural rationality), procedures for gathering and disbursing public money (procedural rationality), and the actual flows

2 Cf. the ten principles of financial law: *authoritativeness, annual basis, universality, unity, specificity, balance* as the classical principles and *accountability, transparency*, *stability* (*predictability*), *performance (efficiency, economy, effectiveness*) as rules considered modern (OECD, 2004: 132-150).

of money gathered and used for public needs (flow rationality) (Szołno-Koguc, 2009: 17-22). The realization of the recommendations shown in the above scope should be comprehensive in nature, combining all the levels mentioned, but could assume a gradual, partial character displaying either the structural, procedural or flow aspect.

4 Structural Rationality of Public Finance

Changes to structures should first and foremost bring about far-reaching and consistent institutional orderliness, including the elimination of anachronistic organizational forms, along with verification of the legal-organizational character of the rest. It is worth pointing out that the reform of 2009 ultimately resulted in only a partial liquidation of state budget-funded entities, leaving such institutions to remain at local authority level, while the abolished ancillary enterprises were in numerous cases replaced by real ephemera in the form of public sector institutions (Szołno-Koguc, 2011: 149-158). State Forests remain outside the public finance sector as an important institution carrying out essential tasks in the field of forestry, the organizational-legal status of the Farmers' Social Security Fund remains unclear.

It is essential to make a clean break from the principle of solving problems using institutionalization itself – the fact that an existing agency or office will continue or a new one is to be created does not automatically mean that a given task will be realized effectively or the situation in a particular area of social or economic life will improve. Such action limits the allocation of public funds and reduces the flexibility of financial management. Restructuring actions implemented successively do, however, constitute an excellent opportunity to review the existing organizational units in terms of the tasks they realize, the efficiency and effectiveness of their use of public funds.

Ensuring the proper institutional framework for the public finance sector in Poland requires constant verification of organizational solutions, increasingly general use via the ESA system of the idea defining affiliation to the general government sector taking into account the functions realized by given institutions as well as the way they are financed.[3] Changes which lead in this direction are an expression not only of the need to adapt the public finance sector to EU standards but also of the aspirations to improve openness and transparency, to meet the requirements of the

3 ESA (*European System of Accounts*) – the European system of national and regional accounts adopted in 1995 (ESA-95), modified in 2010 (ESA 2010). The ESA standard indicates two criteria – redistribution of the national income and wealth as the basic activity of a given entity, and additionally the 50% rule (i.e. less than 50% of production costs are financed from sales income/revenue).

effective management of public funds. Also important is consistency in introducing new solutions, consistency of the regulations adopted in this field with other legislation to avoid doubts regarding interpretation, whether and to what extent a given organizational entity using public money to carry out public tasks creates the public finance sector. A secondary aspect is a matter of whether and to what extent that entity is connected financially with the budget of the state or local authorities as basic institutions of a legal-financial character, serving to redistribute public funds.

5 Procedural Rationality of Public Finance

Procedural changes refer, among other things, to proper management of public funds, they include in particular spending in a deliberate and economical manner, maintaining the principles of obtaining the best effects from given expenditure or the optimal choice of methods and means to achieve the goals set. Unfortunately, both the Public Finance Act and other legislation lack an explanation of what it means to spend public money in a deliberate and economical way. The use of public funds should undoubtedly serve to realize the goals and tasks of socio-economic policy. This is a highly general statement, though, which is difficult to verify in practice if the goals and tasks mentioned are not subject to defined measurements allowing for a reliable and objective assessment of whether and to what extent the costs incurred contributed to their realization. A statutory provision by itself, without a properly developed system for defining goals and tasks both in a qualitative and, as far as possible quantitative (measurable), structure, and monitoring of their realization, and on this basis controlling the desirability of spending increases, has little in common with actual rationalization of public finance management. In English-speaking countries, the principle of desirable and rational public spending is expressed in the 3E rule – economy, efficiency, and effectiveness. These criteria are taken together to control the VFM effect – value for money (Zdasień, 2001: 2).

To improve the effectiveness and efficiency of managing public funds, the reorientation which has been underway for several years from administrative sending to management in the context of the task-oriented system is of key significance. A task-oriented budget can and should be implemented by every institution of the public finance sector, not only at the level of state administration but also by local authorities – each of them realizes defined tasks on behalf of the national, regional or local community, spends public money and it is important that they do so in the most effective way possible, taking into account elements optimizing the costs incurred. The task-based formula assumes that before expenditure is planned for financing defined budgetary tasks, it is necessary not only to verify what specifically is expected to be done, what kind of enterprise, why and what the public authorities want to achieve through this, how they want to do it, whether and to what extent the non-public sector is taken into account, how much it will cost and how much public money this entails, but above all how the effects of the undertaking can be measured. A task-based approach to planning, executing and controlling the budget also improves the openness and transparency of management of public funds.

It is worth noting that a task-based budget concept requires the rules of budget recording to be modified and adapted to international standards, including the implementation of accrual accounting. The illusion of a low budget deficit would finally vanish – there would be more limited possibilities to manipulate its extent by delayed payments, or creative spreading of payments resulting from separate legislation into different categories, as being financed supposedly by revenue from the privatization of Treasury or local authority assets, but in practice (due to these expenses massively exceeding privatization revenue even at the planning stage) by money obtained from treasury bills and bonds, thus increasing the already substantial public debt. Is this open and transparent, and above all consistent with sensible financial management?

The budgetary system should allow for clear delineation of the "own" expenditure of state bodies and the organizational units subordinate to them from redistributive transfers, operational expenditure, and capital expenditure, particularly on investment, with the possibility to indicate the source of financing in the latter cases (own, EU, foreign). Without an appropriate division in this area which does not violate the classical principle of budgetary unity, it is impossible to assess whether and to what extent the increasing public debt is a result of the increasing scale of pro-development investment, or of the ongoing maintenance of the state administration.

The full formula of a task-based budget also requires the creation of an accounts record system which would enable calculation of the actual costs of carrying out tasks, both direct and indirect costs, taking into account the consequences of any abandonment or interruption in its realization.

A necessary condition for the proper functioning of the public finance sector is properly working control of the acquisition and expenditure of funds by public sector entities. An analysis of prior practical experiences in this field gives rise to doubts, particularly with regard to the criteria of the checks conducted and the possibility to use these as the basis of a full evaluation of the financial management of entities being assessed. Managing finances consistently with the applicable legislation is a necessary factor, but not a sufficient one for the effectiveness and efficiency of a given entity's operations. It is thus advisable to extend the control criteria so that its results enable full data to be prepared with regard to the condition of the entire public finance sector, which could be actively used in decision-making processes by both state and local authorities. Transformation of the public finance control model should be accompanied by an evolution away from the significant dominance of the legality criterion to the broad and generally applied criteria of purpose, economy, and effectiveness.

Finally, there is the problem of the audit – specifically the external audit which the public finance sector lacks, at least in the sense of a compulsory check of the budgetary and financial statements by external auditors. A basic problem appears here, that of who should conduct such an audit, assuming professionalism and objectivity of the assessment. Should it be entities which are part of the public finance sector (the Supreme Audit Office or regional auditing chambers?), or auditors from outside the public sector?

Another crucial issue is the system for seeking out responsibility for breaches in the discipline of public finance. Despite attempts at change, this remains dysfunctional to a great degree, does not guarantee that public finance will function properly and does not protect the state's fiscal interests effectively. Systemic reforms are required aimed at increasing efficiency and tightness, not just at cosmetic adjustments designed to retain the status quo of particular bodies and institutions in spite of the changing socio-economic reality. Above all, the aim is to clearly define the legal character of the aforementioned responsibility. The most sensible, and also the most substantively and procedurally justified, solution seems to be to include elements affecting discipline of public finance within the regime of responsibility for fiscal offences and crimes, if not to form a completely separate financial judiciary to adjudicate on breaches of public financial discipline (Szołno-Koguc, 2015: 1).

6 Flow Rationality of Public Finance

Problems connected with the cash flow itself are no less controversial. The reform should aim to specify the conceptual apparatus – revenue and income, expenses and expenditure. The current regulations in the Public Finance Act do not provide a clear picture of the flow of public funds, e.g., when revenue obtained by public sector entities from the business they conduct or other sources counts as income and when as revenue (Public Finance Act of 27 August, Art. 5/2/3-8 and Art. 5/1/5). The main requirements generally refer to reform of the system of public revenue from impositions – the basic foundations of the Polish tax system formed in the early 1990s were subjected in later periods mainly to transformations forced by their adaptation to EU standards, subordinated to interim requirements of fiscal policy and often also to short-term goals in the run-up to elections. This omitted the wide-ranging, multi-level context of the pro-effectiveness and pro-social reforms.

Reforming the tax system requires coordinated and consolidated actions which undoubtedly last longer than one parliamentary term. It is difficult to find any positive examples in this field – on the contrary, interesting proposals are forgotten along with changing governments and parliaments.

The flow context makes it necessary to evaluate what rationalization of public spending means in practice – is it merely the postulate to save or be efficient, or does it result from a model, adopted and consistently realized, of the state, the tasks and duties of public authorities in the social and economic sphere which are accepted not just by political forces but above all by a majority of democratic society. In my opinion, the second belief should be the dominant one because, as I mentioned at the beginning, a goof public finance system cannot be created without a proper basis in a clear and consistently implemented vision of the state (Kosikowski, 2011). Changes to the system of income and expenditure, revenue and expenses, translate directly into the problems of budget deficit and public debt – the cause, nature, and extent of the phenomenon in the context of meeting convergence conditions, but also the broader perspective of security of public finance.

7 Conclusions

Further reforms mean further challenges taken up in search of rational public finance, a system of collecting and spending public money which is consistent with scientific principles and relevant to the conclusions drawn from practical experience in this and other countries. In addition, the changing social and economic reality entails changes to the approach, a redefinition of priorities, appropriate adaptation of structures, procedures and above all of the flow. An analysis of previous experience proves that it is fruitless to seek rationality in public finance, as its system will never fulfill its role properly without a clear and plainly defined vision of the state. It is the realization of that vision which is served by operations involving collection and spending of public funds.

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