Public Financial Management and Its Emerging Architecture

Marco Cangiano
Assistant Director
Fiscal Affairs Department - International Monetary Fund
Visiting Scholar
NYU Wagner Graduate School of Public Service

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Outline

• Why such a book and why now

• Focus on some of the PFM innovations:
  – Medium-term budgetary frameworks
  – Accounting and reporting
  – Fiscal risk management

• What have we learned during the recent crisis

• Considerations on how to strengthen PFM systems
The Book
Why this book and why now

• Main motivation:

“Without strong public financial management systems, many fiscal policies are bound to fail in their implementation, thus endangering macroeconomic stability.”

• Main objectives:

– Take stock of innovations developed and adopted in a growing number of countries over the last two decades.
– Look at public financial management as an integrated framework in which all elements mutually reinforce each other.
– Draw some lessons, particularly in light of recent financial crisis.
Public Financial Management

• In its traditional sense PFM is concerned with established phases of budgeting—formulation, approval, and execution.
• Broadened its focus to all aspects of managing public resources.
• It is an “umbrella” definition, covering a set of systems aimed at producing information, processes, and rules that support fiscal policymaking as well as provide instruments for its implementation.
• Key objectives:
  – Maintaining a sustainable fiscal position.
  – Effective allocation of resources.
  – Efficient delivery of public goods and services.
Emerging Architecture

- **Architecture** conveys how PFM elements are interconnected and mutually dependent and how they can be melded into an integrated framework.

- **Emerging** emphasizes the time dimension and the open system nature of innovations, which are bound to take place at irregular intervals as the demand for better management of public resources increases.

- **Emerging architecture** focuses on the selected elements that have emerged and can now be seen as building blocks of modern PFM.
Conceptual Framework

• Three main instruments—information, processes and rules—to affect the behavior of politicians and public servants and achieve desired outcomes.

• The three instruments form a logical sequence:

  ➢ Information is the essential first step—better information will produce better outcomes.
  ➢ Processes provide incentives for policymakers to make prudent, effective decisions.
  ➢ Rules prescribe actions by policymakers and public servants.

• But each instrument has its limitations:

  – Information, while essential, can be costly, an end by itself, and stir conflict.
  – Processes tend to be dominated by routine and bureaucratic inertia that work against innovations.
  – Rules can be procedural and/or restrictive.
Key Innovations

- The number of countries with some sort of fiscal rule has risen from 5 in 1990 to 76 in 2012.
- The number of countries with a sort of medium-term budget framework has increased from 20 in 1990 to about 130 in 2008.
- There are now 25 fiscal councils compared with 6 in 1990.
- 41 countries are reporting to the IMF at least a financial balance sheet, twice as many as in 2004.
- Since 2007, 80% percent of OECD countries produce performance information, and in 2011 about 2/3 have a performance budgeting framework.
- Since 1999, 111 countries have undergone a “Fiscal Transparency ROSC,” and by the end of 2011, 126 countries had undertaken a PFM diagnostic assessment, such as PEFA.
Summing up

• A set of increasingly complex processes, rules, and systems, intrinsically linked to one another.
• Reliable, timely, comprehensive information is essential but it may lead to overload.
• The relative emphasis has shifted toward fiscal sustainability vis-à-vis efficiency and effectiveness.
• Thus, the focus on medium/long term and fiscal risks.
• Context matters—but “uniqueness” syndrome.
• The architectural design identifies constituent elements and provide general considerations.
• Going beyond that would be pretending to have discovered a magic formula that does not and cannot exist.
Medium-Term Budgetary Frameworks
Where strategy and budget meet

**Objective**

- Fix permanent fiscal objectives
- State multi-year fiscal targets
- Set multi-year spending plans
- Authorize annual expenditure
- Report actual expenditure

**Instrument**

- Fiscal Rule or Responsibility Law
- Medium-term Fiscal Framework (MTFF)
- Medium-term Budget Framework (MTBF)
- Annual Budget
- Final Accounts

**Content**

- Principles of fiscal management
- Numerical fiscal rule
- Disclosure requirements
- Multi-year macroeconomic forecast
- Multi-year fiscal forecast
- Fiscal risk analysis
- Medium-term fiscal target
- Multi-year expenditure ceiling
- Multi-year spending allocations
- Planning margin
- Performance indicators/targets
- Detailed expenditure appropriations
- Other budgetary controls
- Reconciliation of changes from MTBF
- Detailed expenditure outturn
- Reconciliation of change turn from Budget
- Explanation of discrepancies
More than meets the eye

- MTBFs have multiple objectives and are part of a broader set-up (MTFFs)
- No single model, some work better than others *(but take note of country specificity)*
- Effective MTBFs have demanding prerequisites
  - credible annual budget
  - prudent macroeconomic forecasts
  - comprehensive and top-down budget process
- Their design entails more than setting ceilings
  - prioritization mechanisms
  - forward-looking controls
  - transparency and accountability
Accounting and Reporting
Progress, thus far

• Increasing number of countries moving to accruals
• Broader coverage—general government and public sector, WGA
• Harmonization of International standards (GFSM2001, SNA/ESA95 IPSAS, and next EPSAS?)
• Higher frequency, better timeliness
• Long-term fiscal sustainability reporting
Issues

- Comparability of ex ante and ex post information
- Independence of standard setters
- Tax expenditures
Fiscal risk management
What are fiscal risks?

• Short- to medium-term deviations in fiscal variables (flows and stocks) compared with what was anticipated in the budget/forecasts.
  - general economic risks (e.g., lower economic growth)
  - specific risks (e.g., natural disasters), including contingent liabilities (e.g., government guarantees)

• Structural or institutional weaknesses can enhance fiscal risk and constrain effective risk management.
  - few revenue sources $\Rightarrow$ more volatility
  - high debt $\Rightarrow$ less flexibility in response to shocks
Problems

• Conventional budgeting and accounting not adequate tool
  ✓ accrual accounting has clear advantages over cash accounting (information about the future implications of current policies, e.g. civil service pensions)
  ✓ but significant risks are not highlighted (e.g. public-private partnerships or guarantees; private sector indebtedness)

• Information on existing risk exposures needs to be centralized to account for potential interactions and portfolio effects
  ✓ few examples of centralized dedicated units
Proposals

• More active disclosure and management of fiscal risks
• Development of fiscal risk statements (about a dozen countries) either as separate documents or part of budget documentation
• Governments that report according to IFRS disclose information on selected fiscal risks (e.g. contingent liabilities)
• Need to accompany Fiscal Risk Statement with details of what is being done to manage risks--fiscal risk management cycle
• IMF guidelines for fiscal risk management
• But in general still lack of systematic and centralized approach to identifying risk
• Fiscal risk statement should become part of ex ante budget documents, possibly consistent with final accounts
Key Lessons from the Recent Crisis 
or....

Back to the future?
Key Lessons from the Recent Crisis

• Many reforms not well entrenched and introduced in a piecemeal fashion
• Rigid systems and rules broke down
• Emphasis on budget prep and delivery overlooked financial compliance, transparency, and budget execution—expenditure controls insufficiently tight
• Information insufficient—quality, coverage, timeliness
• Transparency and accountability at risk
• Importance of institutions
### Sources of Unexpected Increase in General Government Debt

(Percent of GDP, 2007-2010)

<table>
<thead>
<tr>
<th>Source of Increase</th>
<th>FRA</th>
<th>DEU</th>
<th>NLD</th>
<th>ESP</th>
<th>PRT</th>
<th>GBR</th>
<th>USA</th>
<th>GRC</th>
<th>IRL</th>
<th>ISL</th>
<th>AVE*</th>
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<tr>
<td>Underlying fiscal position</td>
<td>1.7</td>
<td>3.2</td>
<td>-2.4</td>
<td>1.8</td>
<td>11.3</td>
<td>3.7</td>
<td>8.1</td>
<td>16.3</td>
<td>1.3</td>
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<td>Revisions to 2007 deficit &amp; debt</td>
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<td>1.8</td>
<td>-0.9</td>
<td>-0.1</td>
<td>0.1</td>
<td>1.5</td>
<td>7.1</td>
<td>2.5</td>
<td>1.6</td>
<td>4.0</td>
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<tr>
<td>Changes to government boundary</td>
<td>-0.7</td>
<td>1.4</td>
<td>-0.2</td>
<td>0.6</td>
<td>9.4</td>
<td>1.9</td>
<td>0.9</td>
<td>11.2</td>
<td>-0.1</td>
<td>2.5</td>
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<td>Cash-accrual adjustments</td>
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<td>-1.3</td>
<td>1.3</td>
<td>1.7</td>
<td>0.3</td>
<td>0.0</td>
<td>2.6</td>
<td>-0.2</td>
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<td>Exogenous shocks</td>
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<td>12.8</td>
<td>14.2</td>
<td>15.4</td>
<td>8.1</td>
<td>17.0</td>
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<td>60.2</td>
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<td>13.0</td>
<td>4.4</td>
<td>8.9</td>
<td>3.8</td>
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<td>Other factors</td>
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<td>Total Unforecast Increase in Debt</td>
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<td>20.2</td>
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<td>59.1</td>
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*GDP-weighted average

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**Issues Revealed by the Crisis**

- Unreported Deficits
- SoEs & PPPs
- Arrears
- Macroeconomic Risks
- Contingent Liabilities
- Consolidation
Greece: Timeliness of Fiscal Reporting

Revisions to General Government Deficit

(2005-10)

% of GDP

2002 2003 2004 2005 2006 2007 2008 2009 2010

2005 2006 2007 2008 2009 2010
Institutional coverage

Debt of Government Related Enterprises

Percent of GDP

USA 51.5
AUT 46.7
DEU
NLD
CHE
CAN
NOR
JPN
SWE
PRT
FRA
ESP
DNK
AUS

2012
2008
Problems built up over the past 2 decades from outside the general government are now inside.

Portugal: coverage of fiscal reports

Gross General Government Debt
(Percent of GDP)

*Only includes Central Government SOE debt pre 2007
Most slippages in Greece were through in year expenditure over-runs

Greece: Average percentage overspend 2005-2009
Arrears: execution and reporting failures

In both countries, arrears have emerged from outside the budget perimeter

Greece
Arrears ≈ 4.3% of GDP
91% from outside the CG budget

Portugal
Arrears ≈ 3% of GDP
95% from outside the CG budget
Where do we go from here?
Is the glass half full or half empty?

- The reform record is mixed at best
- We know remarkably little about the final outcomes or impacts of reforms on the clients receiving public services or on civil society as a whole
- Difficult to define success
- Reforms never end and modified on the run
- Poor if not lack of ex post evaluation
- Risk of imported best practices
Public Governance and Interest

• Many definitions: *general exercise of authority*.
• Most recent one by IFAC/CIPFA:
  
  _the arrangements put in place to ensure that the intended outcomes for stakeholders are defined and achieved_

• Public interest shares the same ambiguity faced by “public governance.”
• Fundamentally a contextual term
• It requires, for instance, an explicit value judgment on income redistribution, and size of government.
The practice of public sector reform

• Typical triage routine: quick diagnosis and fix to stop the bleeding; overall check up only later
• Role of external players (e.g., OECD, EU, IFIs)
• Response routine:
  – Defense of the status quo (i.e., denial); routine dominance
  – Acknowledgment of potential problems (reluctant acceptance)
  – Full recognition and development of vision (ownership)
Institutionalizing reforms

• Reforms never stops.....

• .....but few countries have a “reform culture” because of ....
  – tyranny of status quo/vested interests
  – perverse HR incentives

• Preparing to sustain reforms, but instead.....
  – under-researched and over-engineered
  – scarce analysis of the implementation phases—usually overly optimistic
  – “best practice’ dominance
  – prevalence of *de jure* over *de facto* implementation gaps
  – top-down; captured by specialists, if externally driven
  – poorly communicated and do not take advantage of key stakeholders and those who will be tasked with their implementation.
Continuity or sustainability

- Many reforms are designed in the absence of a clear vision of the role and functions of the state.
- Reforms coordinated by politically-appointed advisors.
- Top civil service positions subject to political appointments.
- Vertical accountability.
- Certain reforms, such as the proliferation of autonomous bodies institutions, SOEs, and PPPs, an attempt at by-passing budgetary discipline.
Formal over substantial reforms

- Dictated from the top-down, often influenced by international best practices and EU requirements
- Formal compliance nature rather than substantial
- Poorly communicated to the public at large
- Often rushed in their gestation phase, with little attention to the implementation phase
- Rarely “owned” by those in charge of their implementation.
Easier said than done?

Common mistakes

• Prescription before diagnosis.
• Failure to build a sufficient coalition for reform.
• Launching reforms without ensuring sufficient implementation capacity.
• Haste and lack of sustained application.
• Over-reliance on external experts rather than experienced locals.
• Ignoring local cultural factors.

Suggestions

• Based on detailed diagnosis to address real problems.
• Reforms are never a technicality but a bureau-political action.
• Administration should possess the skills to implement the reforms.
• It takes time to come to fruition.
• Maximize use of internal and external expertise and experience.
• Accurate picture of the culture(s) of the organizations to be reformed.
• Reforms can (however unintentionally) undermine existing strengths.
Thank you