

COMPONENTS OF GOOD PUBLIC FINANCIAL MANAGEMENT

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There is now a general consensus among donors and partner countries on what constitutes good PFM, developed in the last three years through extensive diagnostic work, in many cases undertaken collaboratively by a range of donors and collaboratively with the partner country. This consensus is best expressed in the PEFA PFM Performance Indicators Framework¹ published in June 2005. There is also a consensus that the need now is to

- move beyond diagnostics to work with development partners in improving their PFM systems through capacity development programs
- assess the extent to which PFM systems are improving over time, using the performance measurement framework

There are now four generally accepted objectives of a PFM system. It should provide for

- Aggregate fiscal discipline (between and within years)
- Strategic prioritization in composition of expenditure - the budget is a key instrument to implement government policies
- Operational efficiency in use of resources - the budget system should promote efficiency not discourage it
- Fiscal Transparency – to assist in social control, and thus an objective in its own right

However it needs to be recognized that improving PFM is not just a “technical” exercise. Questions of institutions and incentives are also important. For PFM to improve the budget must be perceived by the development partner as a key mechanism for determining government priorities and for delivering services – not just a pro-forma exercise done for the benefit of the Ministry of Finance or of donors. There is a need for ownership of the budget at all levels – the Cabinet collectively and within each ministry the minister, the chief executive and all program managers. There is also the issue of PFM capacity in development partners. Given that this takes time to develop PFM reforms must be realistic; it should not be expected that their PFM systems will reach the level of sophistication of say, OECD countries.

The PEFA PFM framework sets out the following as key components of a good PFM system

- The budget is credible - it is realistic and is implemented. In many countries much effort may be put into preparing budgets which cannot be implemented because they are not realistic. Predictability of donor funding may be an important issue here. The system also needs to discourage unaffordable bids. It should be clear to

¹ Available on the website under www.pefa.org

line ministries how much funding they may expect to receive during the year and what results are expected from that expenditure.

- The internal control system should ensure that the budget appropriations are not exceeded, that funds are spent as intended – as well as ensuring that reliable information is produced. .
- It is comprehensive, covering all government activities. Off budget accounts should be minimized, particularly those for which there is little transparency. Budgeting of recurrent and capital expenditures should be integrated, as should staff budgeting. The relationship between the budget and public enterprises and autonomous agencies should be transparent.
- There is full transparency of budget processes and information. The budget should be developed and implemented through an orderly and understood process. The legislature and the public should have full information on budget results in relation to targets, the government's financial position and the assumptions and risks involved in the budget.
- The budget is a reflection of the government's policies and priorities – the past and expected results of expenditures should be known, as far as they can be reasonably measured.
- There are accounting systems which provide timely and reliable reporting at all levels of decision making – for internal management and control, and for external accountability purposes. Good external reporting needs to be based on good internal reporting.
- The ex post systems of external scrutiny by the legislature and by external audit, by holding ministers and management accountable, should help keep the budget on track and improve performance. These reviews should focus on systems, rather than only on individual incidents or fault finding. Both the legislature and external audit need adequate independence and technical capacity if they are to have impact.

In moving from traditional budgeting, two important new budgetary techniques arise

- Moving way from a one year budget to a medium term approach – not multi-year budget appropriations but preparing the annual budget within a medium term framework, ensuring that it is affordable in the medium term and that it provides information on indicative future funding
- Developing a focus on performance, rather than just budgeting for inputs (salaries, travel etc). While measuring the outcomes or outputs of expenditures is a complex issue and implementing performance budgeting systems has proven difficult even in OECD countries, there is a need to at least have the budget informed by

available performance information – so that it can better reflect government policies and priorities.

Finally PFM systems need to recognize and adapt to two important developments in partner countries.

The first is moves to greater decentralization of functions to sub-national governments. While there are many different models for inter-governmental relations, a general challenge is to develop a system under which the central government has adequate knowledge of what is happening at sub-national government, without it being unnecessarily intrusive.

The second is the challenge of combating corruption. A good PFM system, through comprehensive budgeting, sound internal control systems, reliable information systems and fiscal transparency can assist in this.

Components of Good Public Financial Management

Session 1
Tokyo, 13 March 2006
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Introduction

- General consensus among donors and partner countries on what constitutes good PFM
- Substantial knowledge of partner country PFM systems accumulated through PFM diagnostic work
- Need to move beyond diagnosis to capacity development through country led PFM reform programs
- And to bed down performance management framework for PFM – is it improving ?
- Institutions matter – capacities and incentives (strong MOF, rules observed etc ..)

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PFM Objectives

- Aggregate fiscal discipline (between and within years)
- Strategic prioritization in composition of expenditure - the budget is a key instrument to implement government policies
- Operational efficiency in use of resources - the budget system should promote efficiency not discourage it
- Fiscal Transparency – social control, an objective in its own right

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PFM Objectives

- They are often considered as a hierarchy i.e. Level 1 considered is the most important
- But in any case it is important to understand their interaction and mutual independence e.g. Level 1 may hurt Levels 2 and 3, if short-term expenditure cuts are made
- Achieving Levels 2 and 3 should assist Level 1

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Some Key PFM Issues

Does the budget matter ? Just a pro-forma exercise rather than a key mechanism for determining government priorities and planning service delivery?

Budget is a political *and* technical document

Need for budget ownership – ministers, heads of department and program managers – not just MOF and finance staff

General need for all ministries to take greater responsibility for their own finances - devolved budgeting within a hard budget constraint

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Some Key PFM Issues

- What level of PFM “sophistication” is appropriate for a developing country ?
- PFM problems may reflect lack of incentives for good budget execution rather than lack of capacity.
- Formal rules versus informal rules. What are the incentives for compliance or non-compliance ?
- Avoiding just “technical” fixes – institutional issues.
- To what extent can we improve PFM in isolation from overall public sector reform? (e.g. civil service reform and anti-corruption initiatives)
- Donor behavior may create PFM problems - project ring-fencing, funding uncertainty, lack of information, on donor activity

Key PEFA PFM Components

- Credibility of the budget – it is realistic and is implemented
- Comprehensiveness and transparency
- Policy based budgeting
- Predictability and control in budget execution
- Accounting and reporting – for control, management and accountability purposes
- External scrutiny and audit

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Traditional PFM

- Line item control (inputs)
- One year time horizon, incremental
- Focus on spending and spending controls
- Little knowledge of what is being purchased (outputs)
- Little knowledge of what is being achieved (outcomes)
- Thus weak link between stated policies/priorities and budget allocations
- Little incentive for efficiency
- Budget process may operate through MOF edicts rather than dialogue with spending ministries

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Constructing The Budget

- Basis of budgeting - cash, obligations, accrual ?
- Top down and bottom up approaches - budget dialogue, spending ministry and program manager ownership
- An orderly, predictable, understood and transparent budget construction process – robust dialogue between MOF and spending ministries
- Providing a realistic framework - discouraging unaffordable bids
- National budgeting in a decentralized environment – national priorities with local execution

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Constructing The Budget

- Devolving budget allocations within national government – both to and within ministries
- Determining expenditure priorities
 - the role of systems such as program/performance budgeting
 - prioritizing investment expenditures
- Role of the legislature in budget review – how can it add value. Looking at strategy, aggregates and policies, as well as details
- The value added of participatory budgeting

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Determining The Fiscal Envelope

- Quality of macro-economic forecasts
- Revenue capacity, medium term fiscal targets
- Role of fiscal targets and fiscal responsibility laws
- Donor funding – increasing predictability
- Fiscal realism – of both revenues and expenditures
- Transparency of assumptions
- Managing fiscal risk – contingent liabilities etc

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Comprehensive Budget Issues

- Extra budgetary accounts – degrees of linkage with the budget
- Dual budgeting - lack of integration between capital and recurrent budgets (public investment plan – PIP)
- Separate financial and staff budgeting
- Inclusion of donor funds
- Review of tax expenditures
- Review of Quasi Fiscal Transactions
- Clear relationship of public enterprises and autonomous agencies with the budget

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Medium-Term Approach

- Medium-term fiscal targets - what is affordable?
- Forward estimates of cost of existing policy
- How do forward estimates compare with what is affordable?
- Make the necessary changes/adjustments now-medium-term expenditure planning (not just forecasting)
- Rolling forward each year - the MTEF becomes the budget process

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Medium Term Approach

- Provide indicative forward levels of expenditure allocations - aggregate, sectoral, ministry
- But not multi-year expenditure appropriations or an agreed entitlement
- Provides reasonable predictability to spending ministries
- Consider relationship with multi-year national plans
- Some MTEFs have form but not substance – information is not used

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Issues in Budget Implementation

- Budgets are frequently not implemented !
- It is difficult to implement a badly constructed budget – implementation problems may reflect design problems (comprehensiveness, classification, realism etc)
- And good budgets may be badly implemented
- Relatively good country performance at aggregate fiscal control level. Less so in good resource allocation and operational efficiency?
- Is lack of interest or incentive rather than lack of capacity the reason budget systems work poorly

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Budget Implementation

- Divergences between budget and actual expenditures - size of the divergence is often significant
 - at aggregate, ministry and item level
 - due to unforeseen economic changes ?
 - due to unrealistic budgets - a self inflicted wound
 - due to “policy” changes ?
- Increasing the rate of budget execution – optimistic project/program assumptions or slow revenues ?
- Greater transparency of budget allocations will assist - what are they supposed to get ?

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Budget Implementation

- Improving predictability of funding for spending ministries –important for service delivery and operational efficiency .Orderly and transparent processes
- Increasing the predictability of donor funding
- Need for centralized cash management
- Devolving budgets and holding managers accountable – ex post versus ex ante controls, self control versus external controls
- Timely, reliable and relevant financial reporting needed for management as well as accountability -

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Budget Implementation

- And information systems to enable MOF to monitor ministry expenditures
- Computerized IFMIS assists in information integrity, but don't over-design
- Need for commitment control systems in addition to budget item control in a cash appropriations system
- Achieving transparency in any cash rationing system
- Within-year budget adjustments – additional credits, maintaining order and control, mid-year budget review ?
- Use of contingency reserves etc
- Don't forget revenue management and monitoring

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Internal Control

- General adequacy of internal controls, including procurement and payroll controls and internal audit
- is the system adequate? (control risk)
- Does it operate as intended ? (inherent risk)
- It should include appropriate segregation of duties
- And should be clearly documented, with appropriate training for all actors

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Internal Control

- Internal audit - an aid to top management in ensuring the organization is under control (operating as it should)
- Mechanisms should not be overly complex - complexity may facilitate corruption
- Staffing/payroll controls may be an important aspect (ghost workers, nepotism etc)
- Level of ex ante approvals required before undertaking expenditure – spending unit or MOF controls
- Observing financial rules and regulations – avoidance of exceptional/special procedures

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Fiscal Transparency

- Importance of good fiscal reporting – timely reliable information based on international standards
- But generally a poor aspect of PFM performance
- Budget documents, budget execution reports and annual financial statements
- Budgeting and accounting must be linked
- Good external transparency builds on internal transparency or information flows – which is important for the government's management of its finances.
- Poor external reporting may not reflect a government being secretive about its finances – it may not know

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Fiscal Transparency

- External reporting is one potential form of social control – but who uses these statements and with what effect ?
- Increasing use of government websites to provide fiscal information
- Fiscal transparency legislation may govern some reporting – medium term fiscal frameworks and targets, economic assumptions, fiscal risks
- Transparency of what? Not just financial results and position. But also forecasts, assumptions, plans, results
- What standards should be used – GFS, IPSAS ?

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Fiscal Transparency

- Reliability of information – reconciling fiscal and monetary data
- Annual audited financial statements – may be years late and difficult to interpret
- Information needed on fiscal position as well as results – not just budget execution
- Budget documents may be too voluminous to comprehend
- IMF Code of Good Practices on Fiscal Transparency
- OECD Good Practice on Budget Transparency

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External Audit

- Getting value added from national audit institution – need for independence, capacity and impact
- Avoid “gotcha” approach
- Achieving action on audit reports – the role of the media and the legislature in follow up
- Relative priority of financial auditing and performance auditing
- Need to add credibility to financial statements through financial auditing
- But is anyone interested in the past?
- Do the audit reports raise key issues ?

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External Audit

- Focus is frequently on detailed compliance issues
- Need to focus on systems issues – “road conditions rather than traffic accidents”
- In some countries audit role is detailed ex ante approval of transactions
- If systems don’t work, there is little to audit and audit adds less value
- And the priority may be to use scarce professional resources to improve and operate systems, rather than audit (?)

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Legislative Review

- Role of legislature in ex post review (as opposed to approval of the budget)
- Generally lacks resources and capacity and therefore impact
- Dependent on national audit institution
- Is anyone interested in the past ?
- May usefully hold the Executive accountable and improve government performance in some cases
- But legislators not necessarily interested in financial statements, audit reports, or past events generally
- or even the “public interest.” They may be part of the “problem.”

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Key PFM Anti-Corruption Issues

Comprehensive Budget

- limited off-budget accounts and transparency off-budget activities

Realistic Budget

- unrealistic budgets cannot be implemented and therefore in budget execution the formal budget may be replaced by a non-transparent system of cash rationing – deciding who gets paid

Sound Internal Control Systems

Reliable Information Systems

Fiscal Transparency

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