

Public Financial Management: Planning and Performance

Public Financial Management: Planning & Performance
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Public Financial Management: Planning and Performance

Course Introduction and Overview

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1 Introduction

Welcome to *Public Financial Management: Planning and Performance*. We hope that you will find the course stimulating and useful. Even if you do not have a background in public finance we think you will be able to learn a lot and do well in the assessment for this course. There is technical material and language that may seem to outsiders to be jargon, but we aim to explain the reasoning behind all new terms as we introduce them and to avoid unnecessarily technical language.

It is an interesting time to be studying public finance for several reasons. First, there are changes in the way that the public sector 'does its business'. Bureaucracies with strict hierarchies of public employees carrying out their duties according to a fixed set of rules are giving way, or have already given way, to different ways of working. In some cases there have been programmes of decentralisation and delegation of authority so that managers and professionals at relatively junior levels now have to take decisions based on the best information, including financial information, available to them.

In professions across the public sector, whether medical, educational, legal, engineering or custodial, people are making choices about investments, about how to achieve efficiency, how to stay within budget and how to improve performance. Whether reluctantly or willingly, people are having to understand costs, budgets, financial statements about cash flows and expenditures, even when they are not in accountancy.

In other cases, services are increasingly contracted out to companies, to NGOs or to communities rather than provided directly by public employees. These arrangements require a different set of disciplines – of monitoring other people's performance, of assessing value for money of contracts rather than employees' performance.

To cope with these and other changes, the ways in which public finances are managed have also changed. The days have gone of accounts consisting only of the recording of cash spent, except perhaps at the very frontline of services. Management accounts now commonly have a record of money that has been committed, rather than only of cash spent, allowing managers near the frontline to manage their spending with more confidence. In many countries budgets and accounts are no longer concerned just with the cash allocated and spent but also with the resources used in providing services – capital resources and assets as well as people and materials. The further away from cash accounting the systems get the less they look like our personal accounts and the more we need to learn about the relevant concepts to enable us to understand and run them.

A second reason that public finance is interesting is that in many countries what people are being held to account for is also changing. It is often not sufficient to have accounts that show that money has been spent as governments intended – politicians and the public want to know how *well* it has been spent, whether it has been used *efficiently* and whether it has *achieved the purposes* for which it was allocated. This widening of accountability, combined with the delegation of accountability lower down the organisations, has placed a burden on accounting systems and on the managers and

professionals who have to understand and operate them. Computer systems make financial management easier but managers need to understand the concepts underlying the numbers and the consequences of the financial information that is provided.

Some of these tendencies have led to a narrowing of the differences between private sector and public sector budgeting and accounting: the public sector is now also interested in performance, in the use of assets in service provision and in performance defined as efficiency and effectiveness. Some parts of the public sector now operate on very commercial lines – with revenue and profit targets, competition for customers or contracts – requiring approaches to costing, budgeting and financial reporting that are very similar to those of the private sector.

A third reason that planning and budgeting are currently interesting is that the responses to the financial crisis by governments have put a strain on budgeting systems – the developments in performance-related budgeting, for example, in the UK and in France were made during times of spending growth. When the emphasis of budgets is on deficit reduction and spending cuts, the link between spending and performance may be more difficult to establish.

These trends and tendencies are by no means universal. While some governments have embraced commercial-style accounting and financial management, others have resisted. Some have adopted changes reluctantly but have been forced to change by lenders or donors who have made financial management reform a condition on further lending.

In this course we do not take the view that there is a single best practice in public financial management. The best approach is the approach that produces the desired results. If a simple cash accounting system is adequate to run the financial affairs of, say, a school responsible for the salaries of its employees and the consumables used, then the added complications of asset valuation and accounting for asset use may not help those responsible to manage better. This is especially the case where the decisions made at school level do not include decisions about asset sales and acquisitions. What we try to show is that there are approaches to financial management that can be tailored to the approach to management and governance that governments have adopted.

This implies that a single approach may not be right within one country at all levels of government. For example, if there is a centralised system of tax collection and then a distribution of tax receipts to provincial or municipal governments, then the planning, budgeting and accounting requirements at national and provincial or municipal levels will be different. Similarly, if a public entity operates on commercial lines it needs a commercial-style set of financial procedures. An airport, for example, that is financed by landing charges and franchise sales needs a management accounting system to track revenues and forecast profits or losses. On the other hand, a school whose sole income comes from a government grant needs to track expenditures against budget but would not need a sophisticated system for recording revenues. Both may be operat-

ing in the same jurisdiction. We will try to point out which techniques and methods seem appropriate in which contexts.

Some commentators and advocates of public financial management reform talk as if there is a progression from simpler to more sophisticated systems and that the latter are always better. This can, in our view, lead to the development of rules and systems that are not supported by the right technologies or skills and, in the worst cases, can actually make financial management worse.

While most of the issues discussed in the course are technical, they are not without dispute and dissent. Just as in the private sector there are many examples of 'creative accounting' to make profits look better (or worse) than they really are, so public sector accountants are not above 'creativity'. A favourite is reclassifying expenditure as 'capital' (financed over the period of the asset's life) when it used to be 'current' (to be financed out of this year's receipts) to make this year's current accounts look better. Some people in the accounting profession argue that some of the accounting for deals done under Public Private Partnerships represents at best misleading reporting and at worst false accounting. At a time when European governments were trying to keep their borrowing low to comply with treaty obligations entered to support the launch of the Euro currency, such accounting adjustments were valuable weapons. We take the view that one of the functions of public financial management is to keep the politicians honest and the public informed. This applies as much to simple systems as to sophisticated definitions of assets used and capital consumed.

This course is almost entirely about the expenditure side of public financial management: issues of taxation, borrowing, debt and aid are dealt with in *Public Financial Management: Revenue*, accounting for public expenditure and the audit of public accounts are dealt with in *Public Financial Management: Reporting and Audit*, while issues concerning the financial relationships between tiers of government are covered in *Decentralisation and Local Governance*.

This course starts with a discussion of three elements of the context:

- the macroeconomic framework of the budget
- the accountability framework of the public sector
- the impact of 'new public management' on financial management.

Unit 2 is about the coverage of public budgets and their structure and classification: this unit will help you to read budgets and understand how budgets reflect policy choices.

Unit 3 is concerned with costs and costing systems, and discusses the different ways in which costs can be calculated or estimated according to how the costing information is being used.

Units 4 and 5 are about accounting and budgeting. They explore recent developments in public sector financial management at national levels of government (Unit 4), and at sub-national levels of government (Unit 5).

Unit 6 is about budget implementation and control: it covers the processes between setting a budget and implementing it, what can be done to make

sure that the budget is implemented properly, or if not, to know exactly what has gone wrong and how to correct it.

Unit 7 asks how far financial management can be used to improve public sector performance and explores a variety of experiences in trying to integrate budget management with public sector performance. It concludes by asking whether there is any single, best system of public financial management.

Unit 8 deals with the relationship between politics and budgeting: while all policy decisions implied in budgets are subject to political approval, the processes by which budgets are made involve both legislatures and executives. This unit shows how politicians and the public can be better involved in the process, with case studies from a variety of countries.

During the course you will be asked to do some calculations and to analyse financial statements. Whilst this is not a technical training course, we believe that this sort of practical engagement with costing and accounting issues will help to develop your understanding of the conceptual issues involved.

2 The Course Authors

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Norman Flynn is Programme Director of the Public Policy and Management programme. His publications include *Moving to Outcome Budgeting*, *Scottish Parliament 2002*, *Miracle to Meltdown in Asia* and *Public Sector Management*. He has held academic posts at London Business School and London School of Economics and was Chair Professor of Public Management at City University Hong Kong. He has been a visiting professor at University of the West Indies, Innsbruck University and Strathmore Business School, Nairobi.

3 The Course Structure

Unit 1 The Context of Financial Management

- 1.1 Introduction
- 1.2 What is a Budget?
- 1.3 The Macroeconomic Framework
- 1.4 Accountability
- 1.5 'New Public Management' and Financial Management
- 1.6 Conclusion

Unit 2 Budget Coverage, Classification and Structure

- 2.1 Introduction
- 2.2 Coverage of the Budget
- 2.3 Classification of the Budget
- 2.4 Budget Composition
- 2.5 The Line Item System vs Programme Systems

Unit 3 Costs

- 3.1 Some Definitions of Cost
- 3.2 Costing Systems
- 3.3 Cost-Volume-Profit Model
- 3.4 Absorption or Full Cost Recovery
- 3.5 Activity-Based Costing (ABC)
- 3.6 Managing Costs
- 3.7 Price-Based Costing
- 3.8 Relevant Costs

Unit 4 Accounting and Budgeting: National Level

- 4.1 Approaches to Public Accounting and Budgeting
- 4.2 Cash Accounting vs Accruals Accounting
- 4.3 The Macroeconomic, Fiscal framework and the Medium-Term Expenditure Framework
- 4.4 The Role of the Ministry of Finance
- 4.5 Budget Timetable

Unit 5 Accounting and Budgeting: Sub-National Level

- 5.1 Translating the national budget into operational budgets
- 5.2 Structure, Performance, Discretion, Block Grants and Contracts
- 5.3 Fund Accounting
- 5.4 Resource Accounting and Budgeting
- 5.5 Which Techniques at Which Stage?
- 5.6 Budget Timetable at Sub-National Level
- 5.7 Accounting for Services Provided by Third Parties

Unit 6 Budget Execution

- 6.1 Introduction: Budgetary Control
- 6.2 Controlling Operations
- 6.3 Monitoring Budget Execution
- 6.4 Taking Action
- 6.5 Summary

Unit 7 Budgeting and Performance

- 7.1 Introduction: Accruals Accounting and Output and Outcome Budgeting
- 7.2 Defining and Measuring Non-Financial Items, Especially Outputs and Outcomes
- 7.3 Case Study 1: Output and Outcome Definitions
- 7.4 Output and Input Budgets
- 7.5 Case Study 2: Outcomes and Outputs in Budgets in England
- 7.6 Case Study 3: Performance Budgeting in Canada

7.7 Conclusion: Will Performance Management and Budgeting Ever Be Fully Implemented?

Unit 8 Budgeting and Democracy: Conclusions

- 8.1 Introduction
- 8.2 National Legislatures and the Budget Process
- 8.3 Case Studies – the USA, the Netherlands and Brazil
- 8.4 Conclusions on Budgeting and Democracy
- 8.5 Is There a Single Best Method of Financial Management?
- 8.6 Review: The Journey from Bureaucracy to NPM as it Affects Public Financial Management
- 8.7 Is PEFA the Answer?

4 Learning Outcomes

When you have completed this course you will be able to:

- explain how public budgeting fits into the macroeconomic framework
- apply ideas about accountability to the production of various forms of account for public services and public money
- discuss how changes in public management require different forms of public accounting
- read a budget and a set of national accounts and explain the differences between budgets and accounts in different jurisdictions
- explain costs and different ways of measuring them and how costs are used in budgets
- discuss the budget process at national and sub-national levels and the techniques appropriate at different levels
- apply budgetary control methods
- use financial management to enhance the performance of public organisations.
- discuss how public financial management interfaces with politics and political choices.

5 Course Materials

There are two textbooks.

Andreas Bergmann (2009) *Public Sector Financial Management*, London: FT Prentice Hall.

Bergmann is a professor at Zurich University and brings an international perspective to public financial management. This book provides a 'high-level' view of public financial management, with occasional coverage of the more detailed day-to-day issues.

The second text starts from a more practical viewpoint.

Anwar Shah (ed.) (2007) *Budgeting and Budgetary Institutions* Washington DC: World Bank.

This book arose out of a series of education and training events run by the World Bank, and is written by leading experts in public finance. While Part II of the book is about Africa, the principles, analyses and discussions of practice in Part I are applicable universally. We will not be using Part II on the course, but if you are working in a developing country context, you might find the examples useful.

In addition, there are readings that are mainly case studies of practice in a variety of countries. These are contained in the Course Reader. The course contains case studies of budgeting in a variety of settings, in both developed and developing countries. While context matters in the choice of budgeting and accounting methods, it is the view of the authors that there is probably not one single set of best practice.

To successfully complete the course and the examinations we recommend that you read all of the articles and chapters in the Reader before the examination.

This part of the course is written to introduce you to the scope and the learning objectives.

Reading

At this point, especially if this is your first course in public financial management, we recommend that you turn to Bergmann and read Chapter 1.

Andreas Bergmann
(2009) *Public Sector
Financial Management*,
Chapter 1 'Public sector
financial management'.

In this introductory chapter, Bergmann sets out the scope of his book, but more importantly, the scope of public financial management. He starts with a definition of the public sector, including the general government sector and the public corporations. While there is international agreement about what constitutes the public sector, national definitions require interpretation.

He then goes on to define public financial management in two useful ways:

- the task-based approach, which defines what the tasks of public financial management are
- the institution-based approach, which describes the various bodies involved in planning, spending and accounting for public money.

In this part of the chapter he uses the term 'public sector controlling', by which he means performance management, and 'public sector assurance' which is otherwise known as 'audit'. At this stage we do not need to worry too much about language in this field, except to note that learning about public financial management in English can lead to problems of translation from and into other languages¹.

He then goes on to discuss 'Integrated approaches', specifically the Public Expenditure and Financial Accountability ('PEFA') framework, which has been developed by a consortium of organisations concerned with economic

¹ For example, in German 'controlling' has a more strategic meaning than 'controlling' in English. In Australia the basic unit in budgeting is called a 'product', in France an 'action'.

development. PEFA is used to assess financial management in developing countries but it also provides a useful framework to help us grasp the scope of the financial management system elsewhere. We will return to PEFA at the end of course, in Unit 8.

Please do not read the section on accounting models at this stage – we will give an overview of accounting frameworks later.

6 The Online Study Centre

We would encourage you to use the discussion area of the online study centre to discuss issues with your fellow students. You will be prompted to do so occasionally as you progress through the course. Because public financial management varies greatly across the world, you should find it valuable to check your understanding and experience with your global classmates.

You will be asked to submit your assignments and receive feedback through the OSC, and to ask questions of your tutor. The OSC will also be the main way that we will communicate with you about administrative matters.

7 Assessment

Your performance on each course is assessed through two written assignments and one examination. The assignments are written after weeks 4 and 8 of the course session and the examination is written at a local examination centre in October.

The assignment questions contain fairly detailed guidance about what is required. All assignment answers are limited to 2,500 words and are marked using marking guidelines. When you receive your grade it is accompanied by comments on your paper, including advice about how you might improve, and any clarifications about matters you may not have understood. These comments are designed to help you master the subject and to improve your skills as you progress through your programme.

The written examinations are ‘unseen’ (you will only see the paper in the exam centre) and written by hand, over a three hour period. We advise that you practice writing exams in these conditions as part of your examination preparation, as it is not something you would normally do.

You are not allowed to take in books or notes to the exam room. This means that you need to revise thoroughly in preparation for each exam. This is especially important if you have completed the course in the early part of the year, or in a previous year.

Preparing for assignments and exams

There is good advice on preparing for assignments and exams and writing them in Sections 8.2 and 8.3 of *Studying at a Distance* by Talbot. We recommend that you follow this advice.

The examinations you will sit are designed to evaluate your knowledge and skills in the subjects you have studied: they are not designed to trick you. If you have studied the course thoroughly, you will pass the exam.

Understanding assessment questions

Examination and assignment questions are set to test different knowledge and skills. Sometimes a question will contain more than one part, each part testing a different aspect of your skills and knowledge. You need to spot the key words to know what is being asked of you. Here we categorise the types of things that are asked for in assignments and exams, and the words used. All the examples are from CeFiMS examination papers and assignment questions.

Definitions

Some questions mainly require you to show that you have learned some concepts, by setting out their precise meaning. Such questions are likely to be preliminary and be supplemented by more analytical questions. Generally 'Pass marks' are awarded if the answer only contains definitions. They will contain words such as:

- Describe
- Define
- Examine
- Distinguish between
- Compare
- Contrast
- Write notes on
- Outline
- What is meant by
- List

Reasoning

Other questions are designed to test your reasoning, by explaining cause and effect. Convincing explanations generally carry additional marks to basic definitions. They will include words such as:

- Interpret
- Explain
- What conditions influence
- What are the consequences of
- What are the implications of

Judgment

Others ask you to make a judgment, perhaps of a policy or of a course of action. They will include words like:

- Evaluate
- Critically examine
- Assess
- Do you agree that
- To what extent does

Calculation

Sometimes, you are asked to make a calculation, using a specified technique, where the question begins:

- Use indifference curve analysis to
- Using any economic model you know
- Calculate the standard deviation
- Test whether

It is most likely that questions that ask you to make a calculation will also ask for an application of the result, or an interpretation.

Advice

Other questions ask you to provide advice in a particular situation. This applies to law questions and to policy papers where advice is asked in relation to a policy problem. Your advice should be based on relevant law, principles, evidence of what actions are likely to be effective.

- Advise
- Provide advice on
- Explain how you would advise

Critique

In many cases the question will include the word 'critically'. This means that you are expected to look at the question from at least two points of view, offering a critique of each view and your judgment. You are expected to be critical of what you have read.

The questions may begin

- Critically analyse
- Critically consider
- Critically assess
- Critically discuss the argument that

Examine by argument

Questions that begin with 'discuss' are similar – they ask you to examine by argument, to debate and give reasons for and against a variety of options, for example

- Discuss the advantages and disadvantages of
 - Discuss this statement
 - Discuss the view that
 - Discuss the arguments and debates concerning
-

The grading scheme

Details of the general definitions of what is expected in order to obtain a particular grade are shown below. Remember: examiners will take account of the fact that examination conditions are less conducive to polished work than the conditions in which you write your assignments. These criteria are used in grading all assignments and examinations. Note that as the criterion of each grade rises, it accumulates the elements of the grade below. Assignments awarded better marks will therefore have become comprehensive in both their depth of core skills and advanced skills.

70% and above: Distinction, as for the (60–69%) below plus:

- shows clear evidence of wide and relevant reading and an engagement with the conceptual issues
- develops a sophisticated and intelligent argument
- shows a rigorous use and a sophisticated understanding of relevant source materials, balancing appropriately between factual detail and key theoretical issues. Materials are evaluated directly and their assumptions and arguments challenged and/or appraised
- shows original thinking and a willingness to take risks

60–69%: Merit, as for the (50–59%) below plus:

- shows strong evidence of critical insight and critical thinking
- shows a detailed understanding of the major factual and/or theoretical issues and directly engages with the relevant literature on the topic
- develops a focussed and clear argument and articulates clearly and convincingly a sustained train of logical thought
- shows clear evidence of planning and appropriate choice of sources and methodology

50–59%: Pass, below Merit (50% = pass mark)

- shows a reasonable understanding of the major factual and/or theoretical issues involved
- shows evidence of planning and selection from appropriate sources,
- demonstrates some knowledge of the literature
- the text shows, in places, examples of a clear train of thought or argument
- the text is introduced and concludes appropriately

45–49%: Marginal failure

- shows some awareness and understanding of the factual or theoretical issues, but with little development
- misunderstandings are evident
- shows some evidence of planning, although irrelevant/unrelated material or arguments are included

0–44%: Clear failure

- fails to answer the question or to develop an argument that relates to the question set
- does not engage with the relevant literature or demonstrate a knowledge of the key issues
- contains clear conceptual or factual errors or misunderstandings

[approved by Faculty Learning and Teaching Committee November 2006]

Specimen exam papers

Your final examination will be very similar to the Specimen Exam Paper that you received in your course materials. It will have the same structure and style and the range of question will be comparable.

CeFiMS does not provide past papers or model answers to papers. Our courses are continuously updated and past papers will not be a reliable

guide to current and future examinations. The specimen exam paper is designed to be relevant to reflect the exam that will be set on the current edition of the course

Further information

The OSC will have documentation and information on each year's examination registration and administration process. If you still have questions, both academics and administrators are available to answer queries.

The Regulations are also available at www.cefims.ac.uk/regulations.shtml setting out the rules by which exams are governed.

UNIVERSITY OF LONDON

Centre for Financial and Management Studies

MSc Examination

Postgraduate Diploma Examination

for External Students

91DFMC201

91DFMC301

PUBLIC POLICY AND MANAGEMENT

PUBLIC FINANCIAL MANAGEMENT

Public Financial Management: Planning & Performance

Specimen Exam

This is a specimen examination paper designed to show you the type of examination you will have at the end of the year for Public Financial Management: Planning & Performance. The number of questions and the structure of the examination will be the same but the wording and the requirements of each question will be different. Best wishes for success on your final examination.

The examination must be completed in **THREE** hours.

You must answer **THREE** questions. At least one question from each Section. The examiners give equal weight to each question; therefore, you are advised to distribute your time approximately equally between three questions.

DO NOT REMOVE THIS PAPER FROM THE EXAMINATION ROOM.
IT MUST BE ATTACHED TO YOUR ANSWER BOOK AT THE END OF THE EXAMINATION

Answer THREE questions, at least one question from each section

Section A

(Answer at least ONE question from this section)

- 1 Answer both parts of the question.**
 - a Why do some governments have bigger deficits than others?
 - b When does a deficit become unsustainable?
- 2 When would a public entity best use a line-item budget and when would a programme budget be best?**
- 3 Answer all parts of the question.**
 - a Write short notes on:
 - i marginal cost and average cost
 - ii fixed and variable cost
 - iii absorption costing
 - iv price-based cost.
 - b When would it be appropriate to use each of these when calculating a cost?
- 4 Answer both parts of the question.**
 - a Under what circumstances should public bodies use cash accounting?
 - b When should they use accruals?

Section B

(Answer at least ONE question from this section)

- 5 How does the choice of management system affect the choice of costing system? What are the main causes of budget overspends and underspends?**
- 6 What are the advantages and limitation of using the budget process to manage performance of public bodies?**
- 7 How can budget systems be designed to help politicians make choices about priorities and exercise control over public entities?**
- 8 Do changes in management methods in the public sector necessarily require changes in the accounting methods used?**

[END OF EXAMINATION]

Public Financial Management: Planning and Performance

Unit 1 The Context of Financial Management

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Unit Objectives

The purpose of this unit is to provide an overview of the contexts in which public financial management is done. There are three main elements:

- the overall economic and fiscal contexts within which governments make spending decisions
- the changing nature of accountability in the public sector
- the way in which changes in management practice make new and different demands on financial management.

The relevant context varies according to where you are in the system. If you work in national government, in a central ministry such as the ministry of finance, then the overall economic condition of the country and government's ability to raise taxes, together with its debt position, all have an important bearing on financial decision making. If you are situated in a sub-national government (province, municipality) in a centralised system, these elements are more remote: the national government will hand down grants to your level of government with guidelines about spending priorities. One important element of your context will be the rules by which you raise local taxes and account for the money you spend. If you are a manager, whether in some department at sub-national level, or in an institution, such as a hospital or university, then the management style and procedures will be a very important determinant of the way in which money is controlled and accounted for. In this unit we look at the different levels of the public sector and how the context affects financial management.

It is our intention to help you to understand budgeting and financial and performance control wherever you happen to be located: the view from a Ministry of Finance is very different from the view from an institution in the system. We know that it will take some mental agility on your part as we move from level to level.

Learning Outcomes

When you have completed the unit and its set readings, you will be able to

- outline and discuss the broad macroeconomic foundations of public fiscal policy
- define accountability in the public sector
- explain how changes in management affect financial management.



Readings for Unit 1

Course Reader

David Miles and Andrew Scott (2005) 'Macroeconomics: Understanding the Wealth of Nations', selections from Chapter 10

OECD (2010) 'Restoring Fiscal Sustainability: Lessons for the public sector'

Owen Hughes (2003) *Public Management and Administration*.

1.1 Introduction

This course is about three main issues:

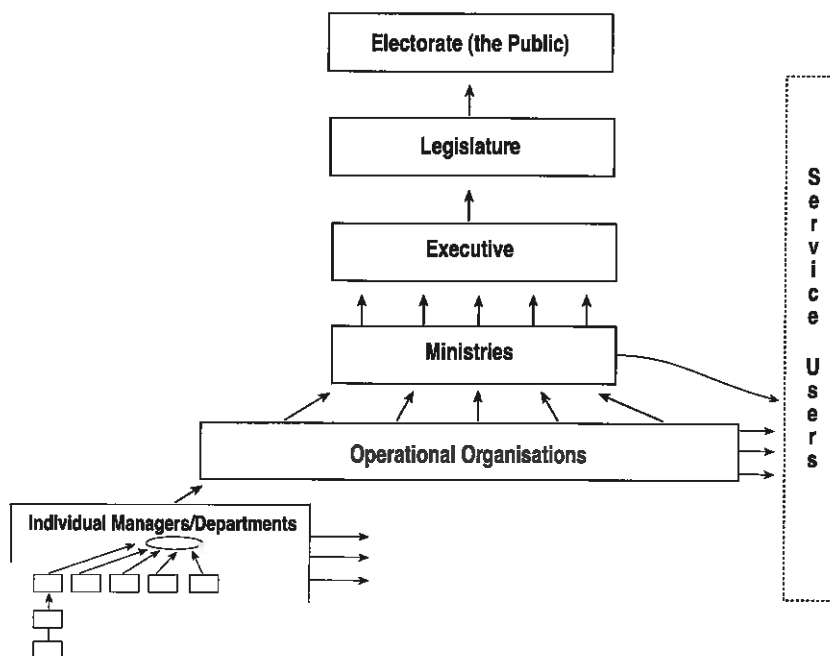
- how budgets are written, including how costs are calculated and how budgets are constructed
- public accountability through the publication of financial accounts
- the management of resources and the contribution that financial management can make to the performance of public services.

Each of these issues is introduced in this unit.

The management of resources covers the whole range of government activities from macroeconomic management and political priorities as set by the legislature right down to the operational level of street cleaning by municipalities. The discussion of techniques requires an understanding of where the organisation lies within the policy making and accountability hierarchies.

Figure 1.1 shows the relationships between legislature, executive and citizens. The processes of public financial management that we will cover in this course involve decision-making and accountability among these main participants in the process.

Figure 1.1 Accountability in Public Finance, the relationships between legislature, executive and citizens



You will see that budgets at national level are mostly written by the executive in a process that involves varying degrees of consultation with legislatures and the citizens. Below national government level, there is a wide variety of processes, from very centralised systems in which sub-national governments simply carry out the instructions of national government to decentralised systems in which sub-national governments make their own spending choices (and to some degree raise their own taxes).

Further down the hierarchy, individual institutions, such as schools, or public universities, have their own financial management processes, again with a variety of relationships with their local or provincial and national governments. As a professional or a politician working in government, the task and the degree of discretion you have depends on where you sit and what sort of system you work in.

At national level, financial management includes big economic decisions about the level of government spending overall and the level of taxation and borrowing. In a centralised system, financial management in provincial or local government will involve spending money handed down by the national government and the accountability will be upwards to central government. In a decentralized system, local governments are more accountable to their local electorates (in democratic systems) and have to take account of local circumstances in their decision-making.

1.2 What is a Budget?

The budget is something that we all have heard about and discussed throughout our lives and careers. However, this familiarity often causes more confusion than help, because we have encountered budgets in different contexts and with different meanings. Financial management, like many other disciplines, uses identical words to mean different things in different contexts.

Exercise

Write down your understanding of a budget and its purpose.

Now compare your understanding of a budget and its purpose with the elements here.

A budget is a quantitative plan for a forthcoming accounting period. Its purpose is multi-faceted and is intended to:

- define an envelope of total public spending for the year ahead
- help with planning and making choices among priorities
- co-ordinate activities of an organisation or of the state
- communicate objectives to the relevant people or organisations
- monitor the performance against the plan
- control activities.

A budget may also be used to

- evaluate performance of departments and agencies.

There are therefore some apparently conflicting roles and it depends on where you are within the decision-making hierarchy as to how you use budgets.

Exercise

Return to the points you made above and consider how they may differ for the various groups identified in Figure 1.1. We will be returning to these groups throughout the course.

We now turn to the macroeconomic framework. We will return to the technicalities of the budget in Unit 2, and to financial and political aspects of budgeting in later units.

1.3 The Macroeconomic Framework

The role of government

The role of the government evolves and responds to political, social and economic events. There are differing views on the role of government. Stephen Bailey writes (2002: p 14):

The interpretation and emphasis placed on market failure concepts is derivative of a government's political perspective. Socialists may prefer Keynesian theory since it can be used to justify very detailed intervention in the economy and society; for example, how much to spend, when, where and on whom. Non-socialists may prefer monetarist theory since it can be used to justify little government intervention (*laissez faire*). They may also be used to believe theories that justify allowing people to keep what they earn (e.g. the theory that taxation causes disincentive-to-work effects)... Rather than politicians being the slaves of some defunct economist (as Keynes claimed), different economic theories may become the politicised intellectual rationales of different political parties.

Reading

To see how these different interpretations lead to very different roles and spending patterns in government, now read Miles and Scott *Macroeconomics: Understanding the Wealth of Nations*, pp 224-29 (Section 10.1 Government Spending), on the variations among richer countries.

David Miles and
Andrew Scott (2005)
pp 224-29 from
*Macroeconomics:
Understanding the
Wealth of Nations*,
reprinted in the Course
Reader

 Your notes on the reading should enable you to answer the following question.

- Why do you think there is such variability in what governments do and how much of the national income governments use?
-

Interpretations

There are various interpretations: different 'models' of how society should be and different national political attitudes, especially towards welfare and other transfer payments:

- a political settlement between taxpayers and beneficiaries of expenditures
- spending as an outcome of bargaining among interest groups, including government agencies.

What is important for public financial management is that different jurisdictions sustain very different policies towards the role of government, the functions and services on which governments spend money and the overall level of public spending. You have seen from Miles and Scott that there is great variation within the OECD countries, and the variation is still greater if you add the rest of the world.

The composition of public expenditure has implications for the sorts of decisions that are made during the budget process. In general, expenditures on transfer payments, including welfare payments, state pensions and subsidies are based on decisions about entitlements. Once a law has been passed that says that all unemployed, disabled or elderly people are entitled to receive benefits, and that the level of benefits is set by some formula (linked to the level of price inflation, for example) then the expenditures on those benefits are predetermined. The budget process can only decide on expenditures on the purchase and provision of goods and services.

Fiscal policy

The other big influence on how much can be spent in any planning period is how much the government can afford. Spending can be financed out of the money raised from taxation and other revenues, such as the sale of oil or licences, and out of borrowed money. The degree to which a government wants to balance its spending with the amount raised in tax and other receipts is its fiscal stance.

A government's fiscal stance will most likely vary over the economic cycle. During recessions government is more willing to run deficits. During economic boom times governments are more able to run surpluses when they collect more buoyant taxes. There are often differences in the attitude to borrowing according to why the money is being borrowed: many governments will happily borrow to pay for capital investment in infrastructure and the like, but are unwilling to borrow to finance current expenditures.

If governments continue to run deficits, they accumulate a stock of debt, on which interest payments have to be paid each year. It is possible to distinguish a primary balance (the difference between spending – excluding interest payments – and tax and other revenues collected in any year) and the overall balance, where interest payments are included in the expenditure calculation. Governments distinguish between these two definitions when making their fiscal policy.

The next reading concerns the overall fiscal policy of governments and deals with the constraints under which national governments make their overall budget decisions, including the stage in the economic cycle and the accumulated debts left over from previous decisions.

Reading

The next three parts of Miles and Scott you are going to read are about debts and deficits. **Section 10.4 Deficits and Taxes**, concerns what has been happening to deficits and to the stock of government debt in recent years (prior to the crisis) in a selection of developed countries.

David Miles and
Andrew Scott (2005)
*Macroeconomics:
Understanding the
Wealth of Nations*,
Sections 10.4, 10.6 and
10.7

Whether deficits and debt are a problem for governments in the long term depends on whether the deficits are sustainable or not. **Section 10.6 Long-Run Sustainability**, from Miles and Scott, provides a definition of sustainability. When you read the section, make sure you understand the argument about the relationship between economic growth, interest rates and primary surpluses and deficits.

Now please read Miles and Scott Sections 10.4, 10.6 and **10.7 Intertemporal Budget Constraint**, and make sure you understand the government intertemporal budget constraint.

 Your notes should cover the points cited above.

One of the important implications of this analysis is that a sustainable fiscal policy (on this definition) depends not on some nominal ideal ratios of debt to GDP (such as the agreement under the Maastricht treaty when the Euro was established¹) but rather on future growth and interest rates as well as the stock of debt.



Reading

In **Section 10.8 Optimal Budget Deficits**, of their chapter, Miles and Scott suggest that there are optimal budget deficits. Please read this Section now.

 Make a note of the circumstances where governments would be justified in running budget deficits.

David Miles and
Andrew Scott (2005)
*Macroeconomics:
Understanding the
Wealth of Nations*,
Section 10.8.

The policy stance on fiscal balance has an obvious impact on budgets. Deficits can be reduced by cutting spending or increasing revenue, but at the same time *future* liabilities need to be assessed within the context of fiscal sustainability. The Bretton Woods Institutions (BWI)² strongly argued that the most effective way to deal with deficits was deep expenditure cuts, and the consequences of such cuts in many countries are well known.

More recently they have qualified this approach with 'poverty alleviation' concerns, but those concerns themselves appear to add to the pressure on future liabilities as the current approaches by the BWI appear to link increased service provision (education, health) with poverty alleviation, and so service provision in poor countries is the single largest driver of expansion of the budget. Tax reform measures can increase total revenues. But the overall issue is that there is a growing pressure on the public sector to increase expenditures, and the central questions in public financial management relate to technical as well as policy approaches to reducing this pressure.

¹ Within Europe those countries joining the Euro area entered a treaty to ensure currency stability. The Stability and Growth Pact (SGP) of July 1997 set out the maximum acceptable level of deficit for Euro countries at 3% of GDP, and accumulated debt at 60% of GDP. During economic difficulties after 2000, first Ireland and Italy and then both Germany and France breached those conditions. After the financial crisis of 2008, almost all countries (the few exceptions included Luxembourg) incurred deficits greater than they planned.

² World Bank and International Monetary Fund.

The financial crisis and budget deficits

This discussion of deficits and the macroeconomic impact of government taxation and spending were largely conducted before the economic crisis that started in 2007. The collapse of large parts of the banking and other financial institutions in the United States of America and in Europe and elsewhere had a big impact on government finances in two ways:

- rescue packages and state control were put in place for many financial institutions
- the credit shortage and recession that followed the financial collapse had a large negative impact on tax revenues.

Taken together, these two factors caused almost all European countries (with the exception of Luxembourg) to break the Stability and Growth Pact/Maastricht Treaty rules on both deficits and the level of debt as a proportion of GDP. Most governments have used their budgets since 2010 to try to redress these deficits and levels of debt.



Reading

A group of senior officials from OECD countries produced a paper on the lessons from the fiscal crisis. The paper, 'Restoring Fiscal Sustainability: lessons for the public sector', is contained in the Reader. You should note that this paper represents the OECD orthodox position on deficits and how to reduce them.

OECD (2010) 'Restoring Fiscal Sustainability: Lessons for the public sector'

 When you read the OECD paper, be sure to cover the OECD's arguments on deficits in your notes. Also consider the question:

- Are there circumstances in which it might not be appropriate to reduce a fiscal deficit? Also be sure to cover the OECD's arguments on deficits.

The answer to that question depends on the position you take on the use of fiscal policy in management of the macro economy. If you think that macro-economic stability can be enhanced by counter-cyclical fiscal policy, then running a higher than normal deficit in a recession is acceptable. If you believe that stability comes only from balanced budgets at all times, then no deficit is ever acceptable.

The deficit and contingent liabilities

We have mentioned the issue of the impact of expanded liabilities of governments that may arise from undertaking incremental obligations. If we announce a policy of increased education spending, we are immediately signalling a possible further requirement for additional government revenues. At the same time, government liabilities include *contingent liabilities*. A *liability* is a present obligation to pay for past events, but as well as past events we need to take into account *commitments* that may incur liabilities in the future. A contingent liability is a possible future obligation to pay. All governments accumulate contingent liabilities.

Contingent liabilities arise for many reasons. The cash basis of the conventional deficit definition over a fiscal year does not take into account future obligations arising from present policies. Public enterprises may make

losses, but if their losses are guaranteed by the state, the losses have to be taken into account in the public finances.

In an ageing society that guarantees tax-funded pensions, demographics present the government with a future liability. Contingent liabilities are subject, as is the budget in general (as we shall discuss in subsequent units), to incremental pressures, increasing fiscal risks over time and the possibility of economic crisis. While these pressures are not great in all countries, demographic trends will make liabilities to older people an increasingly important constraint on budget decisions.

Review Question

To make sure you have understood, pause to answer these questions, based on your reading above.

- 1 How do Miles and Scott define a 'sustainable deficit'?
- 2 Why do some governments have bigger deficits than others?
- 3 How does the economic cycle affect government deficits and surpluses?
- 4 How are the primary deficit (or surplus) and the stock of debt related to each other?

1.4 Accountability

Accountability is part of the governance process. In companies, managers are held to account by the owners through a series of accounts showing how money has been used and with what results. In the public sector there are several accountabilities, reflected in Figure 1.1.

There are a number of different governmental structures such as federal systems (as in the USA and Germany), unitary parliamentary systems (as in the UK and New Zealand), monarchies (such as Qatar and Oman), and communist states (such as Cuba and China). Each structure will have its own lines of command and accountability. Figure 1.1 is necessarily generic but within most democratic systems you will see levels of accountability such as shown.

Each level is accountable to the level above and has control to a greater or lesser extent over the level below. In addition to the accountability to the higher level there is also accountability to the users of the services. While this accountability can take many forms, it is often abbreviated to the *effective management of resources*. This phrase is, however, misleading as all governments have always wished to ensure effective management of resources and there are different models of how this is best achieved.

Financial accountability has changed significantly over the last 50 years. To understand financial management, it is essential to understand the role of accounting, which is sometimes misunderstood. Accounting can still be defined fundamentally as 'the process of identifying, measuring and communicating economic information to permit informed judgments by the users of that information' (*American Accounting Association*, 1966, p. 1). It is important that it therefore meets the needs of the users. It can be seen as a

support activity – i.e. it is there to support the decision making process. How different governments make decisions and how they are held accountable for those decisions will impact heavily on the design and use of accounting and financial management systems. As systems of public management change, the systems of accounting and financial management must also change to prevent the accounting requirements becoming dysfunctional.

In all democratic systems the *public* hold the legislature and executive accountable (through whatever mechanism the political system allows). However, how the lower tiers of state are held accountable varies, as this has undergone a significant transformation, and is continuing to change throughout the world.

Under a bureaucratic system the accountability lies with the legislature and executive. As a bureaucratic system is dependent on rules and processes, the basic assumption that can be identified is that if the processes are correctly applied and efficiently administered, then the outputs from the service will be produced. What needs to be managed therefore is the inputs and the process. From a financial management viewpoint, this will require a simple system to meet the needs of priority setting and input management. The simplest and cheapest accounting system to achieve this is a cash accounting system, which is discussed further in Unit 4.

Under New Public Management (NPM) the assumptions are based on controlling inputs and outputs, allowing managers to be entrepreneurial in how they undertake the processes to achieve outputs. This requires a much more complex set of accounting requirements, as outputs must be matched with inputs. In this case an accruals accounting system, linked with a sound reporting system identifying and recording outputs, is also essential – again considered in detail in Unit 4.

Cash accounting is a term used to describe an accounting system that tracks cash in and out, and records what the money was spent on. *Resource accounting* is a term applied to accruals accounting for governments. *Accruals accounting* does not count cash but records resources used. So, a payment is recorded when it falls due, rather than when cash changes hands. In the case of the use of capital assets, the resources used up are recorded, rather than the cash expended on a capital item.

Resource accounting requires that a balance sheet is produced for state activities, as is explored in detail in Unit 4. With this form of accounting, rather than cash receipts and payments being used to identify deficits, adjustments will be made to take account of investments in future activities. This does not mean that the cash position of a country is not important, but that the cash position is one of a number of factors to be considered when examining state finances.

The change in accounting rules is crucial if the information required by NPM is to be provided for decision-making and accountability purposes. This was first adopted by New Zealand and has been followed by a number of other countries.

1.5 'New Public Management' and Financial Management

New Public Management (NPM) is based on controlling inputs and outputs but allowing managers to be entrepreneurial in how they undertake the processes to achieve those outputs. This requires a much more complex set of accounting requirements as outputs must be matched with inputs. New Public Management is a term that you will be familiar with as an ideal type, if you have studied the course *Perspectives and Issues*. The management processes that fall under the label NPM have varied in different regimes, and initially were confined to the USA, UK, New Zealand – and later with modifications to Western Europe, including France, and some aid-dependent governments. As a generalisation, NPM can be characterised as a set of beliefs and practices based on a critique of 'traditional' ways of managing the public sector. Where possible, practices that introduce competition and give greater discretion to managers are preferred to 'bureaucratic' processes and rule-based procedures.



Reading

Please turn now to the extract from Owen Hughes in the Reader, for an overview of the development of NPM. Hughes overcomes one of the problems with the literature about NPM and tendency to deteriorate into a series of lists. Hughes helpfully collects together the most relevant lists on pages 52 and 53, and then makes his own, and follows with a commentary on his list of 13 items (pp. 54–60).

Owen Hughes (2003)
Chapter 3 (pp 44–60)
of *Public Management
and Administration*,
reprinted in your course
Reader



Make sure your notes cover the main elements of this extract.

You should now be familiar with the idea that NPM represents not exactly a model of management but a set of practices that can be combined, either by taking the whole list or picking convenient parts or those which are easiest to implement. Here we are concerned with the implications of these reforms for financial management in particular.

A strategic approach

Historically it has been common for public sector organisations to produce annual budgets that are essentially last year's budget rolled forward to next year with minor adjustments for price changes. When budgets are produced in this way, there is no need for a long-term approach to financial planning. If the organisation (at whatever level of government) wants to take a strategic approach, then its financial planning needs to be changed. First, time horizons need to be longer than one year, since in any given year a large proportion of the budget will already be committed. To change budget allocations to reflect new priorities requires a time horizon of three years or more. Most OECD-member governments now have multi-year budgets, and many developing countries have 'Medium-Term Expenditure Frameworks', sometimes to satisfy their development partners that public finances are being managed within a strategic framework.

The second implication of taking a 'strategic' approach is that budget discussions and decisions are based on desired results, not just on the

allocation of inputs or resources. For this to be effective, budgets need to contain estimates of outputs and outcomes, as well as the costs of inputs. Financial reporting then also has to extend beyond cash transactions. Strategic management requires fundamental shifts in financial planning and management.

Management not administration: a focus on results

A financial control process that defines and monitors procedures for spending money is sufficient for an administered system: as long as the processes are followed, relevant approvals sought for various levels of spending, vouchers kept and transactions recorded, all will be in order. If management (as opposed to administration) is concerned with the achievement of objectives, then the systems need to cope with measuring and reporting achievements in addition to money spent.

For managers the implication is that they have more responsibility for results, compared to an administrative system. The only problem with the shift in emphasis can be that the cash involved is still public money and still needs to be accounted for. Free-wheeling managers in pursuit of results can often have the brakes applied if it looks as if the financial procedures are being ignored. Managers who have been told to be more entrepreneurial often get frustrated when they are reminded of the need to keep detailed records of all their transactions. It may seem to be paradoxical that accountability becomes more complex when managers are given more freedom to manage; it is, however, the case that as managers are given more discretion, they have to account for their actions in a more complicated way.

Improved financial management

Hughes reports the move towards programme budgeting and accruals accounting, two of the central elements of financial management under NPM. These will be dealt with in detail in Units 4 and 5.

Flexibility in staffing and organisation

One consequence of a more flexible approach to staffing is that staff costs become less predictable and decisions about staffing can be made with an eye to improving efficiency. For example, managers with devolved responsibilities may be able to choose the grade or level of staff they need to complete their tasks, rather than simply be allocated a fixed complement of staff at a fixed grade level, with funding to match. Suddenly, financial planning and monitoring has to take account of the actual numbers of staff and their real pay costs, rather than a simple staffing complement. At the same time, managers have to become aware of labour laws, as they deal with the workforce in a more flexible way.

Competition and markets

When organisations are asked to compete for work with outside contractors, the whole approach to estimating costs changes. Organisations that are not in competition can simply calculate their costs from what is known about staffing, materials costs, overheads etc. Once competition is introduced costs have to be engineered down to the market price that is likely to result from

the competition. The emphasis of management is on cost saving and the emphasis of the financial system is on exposing costs. Accounts have to reflect the trading circumstances of the organisation, recording revenues from customers as well as expenses.

'Contractualism' and the separation of purchaser and provider

Once services are provided under contract, whether internally or with an external provider, the financial monitoring process is split between the 'client' side, responsible for ensuring the service gets provided according to the contract, and the 'producer' side, responsible for making sure that the contract is fulfilled and that costs do not exceed the contract price. Two sets of reports are now required, one for each side of the transaction. In theory the 'client' side is not interested in the details of the costs incurred by the contractor, only the 'bottom line' or bill payable. The contractor side is very interested in all aspects of costs and wants reports on costs quickly enough to take action if costs are getting out of control.

Private sector management practice

There exist in the public sector many myths about how private companies operate, with regard to information systems, freedom of managerial action and level of management skill. This leads managers to try to emulate the private sector, not necessarily by following their actual practice but sometimes a myth about what the practices might be. Hughes emphasises incentives that may be stronger in the private sector. There has certainly been an increased use of financial incentives in NPM regimes and this has implications for financial management, especially in the design of robust measurement systems to ensure that incentive payments are made accurately and visibly.

Relationships with politicians

Unit 8 is concerned with the relationship between politicians and the budget process. NPM, according to Hughes, implies that the relationship between managers and politicians becomes both closer and more fluid. Certainly the emphasis on performance and performance monitoring has an impact on political reputations. Very explicit and measurable targets for public organisations put politicians in a vulnerable position: their promises can later be checked against achievement. The interpretation of targets in budgets is discussed in Unit 7.

What government does

The constant re-examination of what government does has implications for the planning stage of budgeting: before plans can be made, departments have to justify their existence and the value of what they do. This process has been part of the budget planning process in Canada and Australia, as Hughes reports, and in many other jurisdictions.

1.6 Conclusion

You should now understand that balanced budgets are not necessary at all periods in the economic cycle, and that governments run budget deficits for a variety of reasons.

This introductory unit has also covered some of the changes that have occurred in public financial management with regard to accountability and management. It has tried to show that accountability and management in the public sector both require an approach to financial management and financial reporting that is distinct from practices in the private sector. You will see as you work through the course that there are pressures for convergence of the accounting approaches in the public sector towards private sector accounting standards.

At the beginning, the unit defined the purpose of public budgeting. However, we have not yet examined public budgets in any detail. The next unit looks in more detail at the structure of the budget in the public sector.



Review exercise

Check that you can define the following terms:

- transfer payments
- entitlements
- capital expenditure
- primary deficit
- sustainable deficit
- contingent liability
- accounting
- cash accounting
- accruals accounting
- New Public Management.

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