

EXCERPT

Public Financial Management and Its Emerging Architecture



EDITORS

Marco Cangiano, Teresa Curristine,
and Michel Lazare

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Note to Readers

This is an excerpt from *Public Financial Management and Its Emerging Architecture*. The first two decades of the twenty-first century have witnessed an influx of innovations and reforms in public financial management. The current wave of reforms is markedly different from those in the past, owing to the sheer number of innovations, their widespread adoption, and the sense that they add up to a fundamental change in the way governments manage public money. This volume takes stock of the most important innovations that have emerged over the past two decades, including fiscal responsibility legislation, fiscal rules, medium-term budget frameworks, fiscal councils, fiscal risk management techniques, performance budgeting, and accrual reporting and accounting. Not merely a handbook or manual describing practices in the field, this book instead poses critical questions about innovations, the issues and challenges that have appeared along the way, including with the global economic crisis, and how the ground can be prepared for the next generation of public financial management reforms.

The Table of Contents and Introduction are included in this excerpt.

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Public Financial Management and Its Emerging Architecture

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“Governments across the world are constantly searching for ways to improve their public financial management systems. This impressive book covers many of the questions that get asked in this search. It offers insightful perspectives on the challenges of managing public money and will inspire and inform reform ideas across the globe for years to come. Academics and practitioners alike should keep a copy close at hand. I certainly will.”

Matt Andrews, Associate Professor of Public Policy, Kennedy School of Government, Harvard University; author of *The Limits of Institutional Reforms in Development: Changing Rules for Realistic Solutions*

“Faced with growing debt and an uncertain macroeconomic outlook, many governments are experimenting with institutional innovations such as new budgetary rules and fiscal councils. Yet the naïve import of reforms has uncertain benefits. This much-needed book seeks to avoid simplistic prescription, and fosters awareness of the coherence and context of budget institutions. It is an indispensable guide for postcrisis fiscal designers.”

Joachim Wehner, Associate Professor of Public Policy, London School of Economics and Political Science; author of *Legislatures and the Budget Process: The Myth of Fiscal Control*

“This timely volume helps us all better understand the bow wave of public financial and fiscal policy reforms that have been initiated by thoughtful practitioners in nations around the world. Thanks to the chapters by leading public finance analysts, we now have a comprehensive conceptual framework to assess the practices adopted by individual nations, often in the heat of a financial crisis. This couldn’t come at a better time, as leaders and analysts alike will need better guideposts to help nations achieve more sustainable and rationalized public finances in the tumultuous years to come.”

Paul L. Posner, Director, Public Administration Program,
George Mason University

“This helpful volume analyzes the key public financial management innovations that took place over the past two decades. Grouping these innovations loosely into three categories—information, processes, and rules—the authors argue that public financial management is an integrated framework with its own architecture, logic, and connections. There may not therefore be a direct link between individual innovations and outcomes, and general advice is not likely to fit any specific country. The book also poses some intriguing questions, such as what is the likelihood that innovations developed in more advanced economies will work in developing countries.”

Irene S. Rubin, Professor Emeritus of Public Administration, Northern Illinois University; former editor-in-chief, *Public Administration Review*; author of *The Politics of Public Budgeting and Balancing the Federal Budget: Eating the Seed Corn or Trimming the Herds*

“In the wake of the financial crisis public resources are particularly scarce. Thus, effective and efficient use of taxpayers’ money requires sound financial management and full transparency: citizens, parliaments, and financial markets deserve a clear picture of where public finances stand. This book provides an impressive overview of country practices, reforms and innovations in the area of public financial management. This timely publication is a rich source for practitioners in public administrations as well as for the academic community and the interested public.”

Gerhard Steger, Director General of the Budget, Austrian Ministry of Finance;
Chair, OECD Working Party of Senior Budget Officials

“The most comprehensive and informative guide on public financial management! It is well-timed as well. I certainly believe that it will be well received in the Asian region, including Korea, where the importance of PFM is being recognized more than ever.”

Won-Dong Cho, President, Korean Institute of Public Finance

“In this comprehensive survey of current trends in public financial management, the authors present and analyze PFM instruments and practices from around the world. Their analysis is firmly empirical, based on a broad spectrum of sources, and the presentation is balanced; no reader is left with the impression that sophisticated techniques can replace political commitments and hard work. This anthology will for a long time remain a rich source of information for both practitioners in ministries of finance and academic researchers.”

Per Molander, former Director-General; architect of Swedish budget
reform of the 1990s

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Foreword

Public financial management (PFM)—the fine art of budgeting, spending, and managing public monies—has undergone a “revolution” since the late 1980s. This uniquely interdisciplinary combination of economics, political science, public administration, and accounting has seen an influx of innovative ideas and reforms that have sought to address some of the perennial challenges of managing public finances.

To constrain the likely temptation to increase expenditure and spend, rather than save, in times of plenty, countries have introduced fiscal rules and fiscal responsibility laws. To understand and plan for the impact of today’s policy choices on finances in the years ahead, governments have adopted medium-term budget frameworks. To help guard against over-optimistic economic and budgetary estimates, some countries have established independent fiscal councils. To shift the focus of decision making from how much money programs receive to the results they can achieve, many governments have introduced performance budgeting and management initiatives. To better understand the true state of public finances and underlying risks, some governments have sought to increase the comprehensiveness and coverage of fiscal reporting and accounting and have introduced risk management techniques. This profound wave of change in the ways public spending is managed largely started in Australia, New Zealand, and the United Kingdom and has since then passed through virtually all advanced economies, and to some extent, has also reached emerging market economies and low-income countries.

While the field of PFM has changed dramatically over the last two decades, very little has been written about this revolution, with the exception of a few specialized articles. In filling this gap in the literature, this book takes advantage of the unique perspectives provided by IMF public financial management experts, who, over the last two decades, have gained practical experience with many if not all of these reforms and are well placed to draw lessons, make sense of the PFM revolution, and share their cross-country experiences of what has worked in practice and what has not.

The book poses critical questions about these reforms and evaluates what they have accomplished and the issues and challenges they have encountered, including with the global financial and economic crisis. The crisis highlighted the critical importance of a sound public financial management framework in ensuring that well-designed fiscal policies are effectively implemented. But it also demonstrated the underlying limitations of some countries’ PFM frameworks and the flawed design and weak implementation of some PFM innovations, as well as their failure to entrench themselves. Based on these experiences, this book draws general lessons to help guide reformers in their pursuit of the next generation of PFM reforms.

The IMF remains committed to working with all its member countries to provide advice and assistance on public financial management, drawing on its deep experience of working on these issues all over the world. I hope that this publication will help countries meet the challenges of managing public finances in an increasingly complex and uncertain global environment.

Christine Lagarde
Managing Director
International Monetary Fund

Acknowledgments

The idea for this book came from a conversation with Professor Allen Schick in which we discussed how public financial management has developed over the past two decades. Subsequent conversations led to the conclusion that Professor Schick and the staff of the IMF's Fiscal Affairs Department had rich and unique academic and practical experiences to share on how public financial management reforms have evolved and the emerging state of the discipline at the beginning of the twenty-first century. Special recognition goes to Professor Schick for his role in propelling the project and acting as a sounding board for all of us.

This book was a joint effort involving the staff of the two Public Financial Management Divisions of the Fiscal Affairs Department. A large number of friends and former colleagues contributed by reviewing and commenting on various versions of the chapters as well as by participating in a number of lively internal seminars. The work of the entire Fiscal Affairs Department, under the leadership of its Director, Carlo Cottarelli, has provided a stimulating environment in which parallel projects have kept our eyes open, particularly to the views of the nonspecialists. There was, however, no substitute for the many interactions with member countries and colleagues from sister institutions. These interactions provided a much-needed reality check as the elements of the public financial management architecture started to emerge. Participating compatriots included past and present generations of public financial management specialists of the Fiscal Affairs Department, who have generously given us their time, wisdom, and experience, in an attempt to make this book accessible to the uninitiated. In addition to the chapter authors and the staff of the two Public Financial Management divisions, we wish to thank the reviewers, Xavier Debrun, Manal Fouad, Greg Horman, Bacari Kone, Florence Kuteesa, Lewis Murara, Peter Murphy, Sailendra Pattanayak, Mario Pessoa, Dimitar Radev, and Xavier Rame, for their insightful comments and suggestions. We also wish to express our gratitude to our administrative assistants Molly Abraham, Tracy Bowe, Veronique Catany, and Sasha Pitrof for their support, and especially Melinda Weir, who was instrumental in bringing the project to completion. We are very grateful to Michael Harrup of the IMF's External Relations Department for coordinating the production of the book. We thank all of you and especially our families and friends for their patience and support throughout this project.

Marco Cangiano, Teresa Curristine, and Michel Lazare

Abbreviations

CBA	central budget authority
CBO	Congressional Budget Office (United States)
CEMAC	Central African Economic and Monetary Community
CFI	central fiscal institution
CMU	cash management unit
CPIA	Country Policy and Institutional Assessment
DMO	debt management office
ECCU	Eastern Caribbean Currency Union
EITI	Extractive Industries Transparency Initiative
EU	European Union
FMIS	financial management information system
FRL	fiscal responsibility law
G-8	Group of Eight advanced economies
G-20	Group of Twenty advanced economies
GAAP	generally accepted accounting principles
GDP	gross domestic product
<i>GFSM</i>	<i>Government Finance Statistics Manual</i>
HIPC	Heavily Indebted Poor Countries
IFI	international financial institution
IPSAS	International Public Sector Accounting Standards
IT	information technology
MTBF	medium-term budget framework
MTDS	medium-term debt management strategy
MTFF	medium-term fiscal framework
NCoA	National Commission of Audit (Australia)
NDP	national development plan
NPM	new public management
OECD	Organisation for Economic Co-operation and Development
PB	performance budgeting
PEFA	Public Expenditure and Financial Accountability
PFM	public financial management
PI	performance information
PIP	public investment program
PPP	public-private partnership

ROSC	Report on the Observance of Standards and Codes
RRA	resource revenue account
SGP	Stability and Growth Pact
SOE	state-owned enterprise
T-bill	treasury bill
TSA	treasury single account
UN	United Nations
VAR	value at risk
WAEMU	West African Economic and Monetary Union

The Emerging Architecture of Public Financial Management

MARCO CANGIANO, TERESA CURRISTINE, AND MICHEL LAZARE

If a single word could encapsulate public financial management (PFM) in the first decades of the twenty-first century, it would be *innovation*. This book takes stock of key, groundbreaking practices that have emerged over the past two decades in this uniquely interdisciplinary field, including, among others, fiscal responsibility laws, fiscal rules, medium-term budget frameworks, fiscal councils, new fiscal risk management techniques, and performance budgeting. It evaluates what these innovations have accomplished and how they have changed the way we think of PFM—from how governments administer their budgets to how they manage their fiscal policy and public finances. The aim of the book is to sketch the elements of PFM and highlight their interdependence, while being accessible to as broad an audience as possible, but in particular to policymakers who must deal with the increasing complexity of managing public resources.

Although the book was conceived and written in the midst of a grave financial crisis, it is not about the crisis. Nor is it a PFM handbook or manual, which would merely describe PFM practices. Rather, this book poses critical questions about innovations, what has been achieved, the issues and challenges that have appeared along the way, and how the ground can be prepared for the next generation of PFM reforms. The focus is mainly, but not exclusively, on advanced economies—where most of the innovations discussed in this book originated. Innovation has always been an aspect of PFM. The current wave of reforms is different, however, because of the sheer volume and pace of innovations, their widespread adoption, and the sense that they add up to a fundamental change in the way governments manage public money.

WHAT IS PUBLIC FINANCIAL MANAGEMENT? AN EVOLUTIONARY DEFINITION

PFM in the narrowest, and perhaps most traditional, sense is concerned with how governments manage the budget in its established phases—formulation, approval, and execution. It deals with the set of processes and procedures that cover all aspects of expenditure management in government. It is also interdisciplinary, drawing from economics, political science, and public administration, as well as accounting and auditing. But as its relevance in fiscal policymaking has evolved

over time, so has its definition. The simple passage from *expenditure* to *financial* management has broadened its focus from the narrowly defined budget to all aspects of managing public resources, including resource mobilization and debt management, with a progressive extension to the medium- to long-term implications and risks to public finances from today's policy decisions. The coverage of PFM has thus expanded from the narrowly defined central government budget to all levels of government and the broader public sector, including state enterprises and public-private partnerships.

Furthermore, PFM is now seen as an “umbrella” definition, covering a set of systems aimed at producing information, processes, and rules that can help support fiscal policymaking as well as provide instruments for its implementation. Having in place inappropriate budgetary processes and rules can cause unsustainable increases in expenditure and unbudgeted liabilities. Poor or nonexistent financial information, as can result from unrealistic projections of economic growth or nondisclosure of fiscal risks, can undermine government finances. It is this linkage of policies and processes that highlights the importance of PFM and has stimulated recent innovations in PFM practices. That said, PFM is not a substitute for fiscal policymaking; it cannot provide answers to questions about the optimal level of public indebtedness, the proper size of government, and the fair distribution of resources.

The key objectives of public financial management—maintaining a sustainable fiscal position, the effective allocation of resources, and the efficient delivery of public goods and services—have long been established in the literature.¹ The emphasis of this book is on the set of systems, processes, and rules that can counter the well-documented deficit bias inherent in the political process.² As the book argues, information on past, current, and future fiscal developments is of paramount importance in this regard—without sustainable public finances, effectiveness and efficiency run the risk of becoming secondary objectives. In this respect, PFM has certainly evolved from its traditional focus on financial compliance and control to become a key foundation for macrofiscal analysis and policymaking.

It is important to dispel a potential misunderstanding of the meaning of the first PFM key objective, maintaining a sustainable fiscal position. This objective should not be seen as, and certainly does not imply, a bias toward fiscal tightening. It is a way to achieve legitimate macroeconomic objectives, most notably inclusive and balanced growth, in an orderly fashion without prejudging the state of public finances, which may, in turn, have negative repercussions on macroeconomic stability and growth.

¹ Since the early 1990s, these objectives have been the standard PFM objectives used in academia and by the IMF and the World Bank and other international financial institutions.

² The deficit (and debt) bias has been analyzed and explained by various authors as a common pool resource problem (Weingast, Shepsle, and Johnsen, 1981), a prisoners' dilemma (Hallerberg and von Hagen, 1997), time inconsistency and principal-agent relationships (Kydland and Prescott, 1977).

PURPOSE OF THIS BOOK

The objective of this book is to assess selected PFM innovations and reforms introduced during the past 20 years. It aims to explain how reforms have worked; to examine the issues that have emerged in their design and implementation; to compare experiences with expectations; and to provide an understanding of how differences in government capacity affect PFM initiatives. The hope is that readers will take away an enhanced understanding of the prospects and problems associated with contemporary PFM reform.

The PFM literature has grown rapidly in this period, but it is fairly specialized and addresses a specific audience.³ Very few attempts have been made to take stock of how PFM has evolved over the last two decades.⁴ This period has also seen the introduction of a number of PFM diagnostics, most notably the 1998 IMF Code of Good Practices on Fiscal Transparency, with the associated diagnostic, Reports on the Observance of Standards and Codes (ROSCs), and the 2002 Public Expenditure and Financial Accountability (PEFA) assessment.⁵ It is also somewhat surprising—and disappointing—that despite the hundreds of thousands of civil servants and practitioners involved in this area around the globe, PFM is virtually absent from any economics or even public finance curricula; a multitude of specialized courses can be found in political science or public administration, and in accounting, auditing, and project evaluation, but very few attempt to bring together the interdisciplinary approach modern PFM requires. This book attempts to fill this gap in the literature.

What are the key PFM innovations discussed in this book? They include, among others, new legal frameworks to promote fiscal responsibility, fiscal rules, medium-term budget frameworks (MTBFs), fiscal councils, new fiscal risk management techniques, performance budgeting, and accrual reporting and accounting. How have these reforms emerged over the past two decades? Some general facts and trends about their development are highlighted in the following:

- The number of countries with fiscal rules rose from 5 in 1990 to 76 in 2012.
- The number of countries with MTBFs increased from fewer than 20 in 1990 to more than 130 in 2008.

³Pretorius and Pretorius (2008) provide a comprehensive review of PFM literature, but are mainly focused on the *vexata quaestio* of how best to sequence PFM reforms in developing countries. See also Diamond (2012a) for a contribution to this topic.

⁴Many handbooks and manuals were published in the late 1990s and early 2000s, largely driven by the need to deal with transition economies. See Premchand (1993); Schick (1998); Allen and Tomassi (2001); World Bank (1998); Potter and Diamond (1999); and Schiavo-Campo and Tomassi (1999).

⁵The IMF's Code and associated *Manual on Fiscal Transparency* were issued in 1998, modified in 2007 (see IMF, 2007), and substantially revised in 2013. The PEFA program was founded in 2002 as a multidonor partnership between the European Commission, the IMF, the World Bank, the French Ministry of Foreign and European Affairs, the Norwegian Ministry of Foreign Affairs, the Swiss State Secretariat for Economic Affairs, and the U.K. Department for International Development. Its aim is to assess the performance of public expenditure, procurement, and financial accountability systems.

- The number of countries with fiscal councils grew from about 6 in 1990 to about 25 in 2013. A sharp increase has occurred recently, with ten or more such councils having been created since 2008.⁶
- With the emergence of new fiscal reporting standards, the number of countries reporting at least a financial balance sheet to the IMF increased from 21 in 2004 to 41 in 2011.
- By 2007, 80 percent of Organisation for Economic Co-operation and Development (OECD) countries produced performance information, and in 2011 nearly 70 percent had a standard performance budgeting framework.
- Since 1999, 111 “Fiscal Transparency ROSCs” have been conducted, covering 94 countries, and by the end of 2012, 285 PEFA assessments had been undertaken, covering 135 countries.⁷

The word *architecture* is used in the title of this book to convey how PFM elements are interconnected and mutually dependent and how they can be melded into a comprehensive structure. Borrowing from Premchand’s analogy, PFM is “like weaving a Persian carpet, where every tiny knot is as important as the grand design itself” (Premchand, 1993, p. 6). *Emerging* points to the fact that the past 15–20 years have seen the adoption of a number of innovations, some of which have now become part of the PFM lexicon, whereas others have been abandoned and others are still being tested. It also emphasizes the time dimension, given that innovations require lengthy gestation and implementation phases; it stresses how PFM is an open system in which waves of innovation are bound to take place at irregular intervals as the demand for better management of public resources increases. Finally, *emerging architecture* implies that the focus of this book is on the selected elements that have emerged in the last two decades and can now be seen as building blocks of modern PFM—along with others that are not specifically covered in this book but are also important.⁸

Looking at PFM as an integrated framework or system can illuminate important issues. For instance, when reforms are launched in isolation from one another, interested governments may not be aware of their interdependence.⁹ Viewed in isolation, each innovation has its own constituency, terminology,

⁶This is the number of fiscal councils as of February 2013. For more details see the IMF Fiscal Council Database (forthcoming), as well as IMF (2013).

⁷For more details on the ROSCs, see IMF (2012). In 2013, the IMF substantially revised the Code of Good Practices on Fiscal Transparency and the corresponding diagnostic tool, the ROSC. A revised ROSC is due to be launched at the end of 2013.

⁸Essential aspects of PFM that are more focused on budget execution, such as treasury single account, commitment control and reporting, and government financial management information systems, have been developed and implemented for some time. Nonetheless, they remain critical because quite a number of countries still lack these essential features of the PFM armory. Besides the manual referenced in note 5, short and accessible material on these aspects can be found in the Technical Notes and Manuals series the IMF Fiscal Affairs Department has been producing for the last few years. They are all available via the IMF PFM blog at <http://blog-pfm.imf.org/>.

⁹For instance, information contained in financial statements helps in compliance with fiscal rules; changing the basis of budgetary controls from input to output can promote efficiency in the delivery of public goods and services.

information requirements, and procedures that may get in the way of others. This is when government expectations for improvement are frustrated, leading to administrative overload and reform fatigue. Properly designed, an integrated PFM agenda can highlight interdependencies among elements and enable government to select the course that fits its needs and capacity. The system frame of reference also highlights the persisting tendency among public finance specialists and policymakers to split policy design from implementation. In modern and increasingly complex economies, one cannot be conceived without the other.

Finally, advanced economies have been fertile breeding grounds for PFM innovations, but low-income countries have been the main venues for comprehensive reform efforts. The profound differences among countries do not mean that PFM improvements are beyond the reach of countries beset by significant shortcomings. The differences do suggest, however, that innovators should be mindful of sequencing issues and capacity constraints. Architecture is always important; in low-capacity countries, it is critical.¹⁰

PUBLIC FINANCIAL MANAGEMENT IN THE WAKE OF THE FINANCIAL CRISIS

The ongoing financial and economic crisis has proved to be quite a test for PFM. It has revealed how many reforms were far from being well entrenched. For instance, expenditure control mechanisms turned out to be weaker in practice than expected, and some countries in financial distress saw expenditure arrears increase very rapidly. Numerical fiscal rules and targets have proliferated in the past 15 years, and have often been seen as a means for addressing all fiscal problems—chiefly rising deficits and debt levels but also accountability and responsibility gaps—while relegating other vital PFM elements to a supporting role (Wyplosz, 2012). But the record to date is far from compelling, with the overall lackluster performance of numerical rules that were introduced in isolation rather than as part of a more coherent expenditure framework. It is most welcome and timely that the European Commission has focused on other essential PFM elements as part of its Fiscal Compact.¹¹

The crisis has focused attention on two aspects of PFM that have been somewhat neglected in the last two decades but are at its very core: budgetary institutions and fiscal transparency. A well-established body of theoretical and

¹⁰ It is important to stress that there is no automatic relationship between low capacity and low income. Certain advanced economies have revealed, particularly in the wake of the financial crisis, lower-than-expected PFM capacity, whereas capacity in a number of emerging market economies and even low-income countries has been growing quite rapidly.

¹¹ On December 13, 2011, the reinforced Stability and Growth Pact entered into force with a new set of rules for economic and fiscal surveillance. These new measures, the so-called Six Pack, comprise five regulations and one directive proposed by the European Commission and approved by all 27 member states and the European Parliament in October 2011. The Six Pack was followed in March 2012 by the intergovernmental agreement—not an EU law—the Treaty on Stability, Coordination and Governance, the fiscal part of which is commonly referred to as the Fiscal Compact. The treaty is binding for all euro area member states.

empirical analysis shows how budgetary institutions can influence fiscal outcomes.¹² From the perspective of this book, institutions are defined as the laws, procedures, rules, and conventions—including the bodies created by those norms—that influence fiscal policy decision making and management. Strong institutions can improve fiscal performance by highlighting the need for sustainable policies, exposing the full cost of public interventions, and raising the cost of deviating from stated fiscal objectives. By increasing the credibility of announced policies, strong institutions can also foster more favorable macroeconomic conditions and improve market confidence, which further support the restoration of fiscal sustainability.¹³

Key among the institutional arrangements are those that allow governments to have a full understanding of the current state and future evolution of the public finances, including exposure to contingent risks. But some governments are simply unaware of their true fiscal state and the exposure of their public finances for sheer lack of available information, despite concerted efforts to develop a set of internationally accepted standards for fiscal reporting and to monitor and promote the implementation of those standards at the national level. Thus, the understanding of many governments' underlying fiscal positions and the risks to the fiscal positions remains inadequate.

As discussed in a recent IMF paper (IMF, 2012), the financial crisis revealed that, even among advanced economies, governments' understanding of their current fiscal position was inadequate, as shown by the emergence of previously unrecorded deficits and debts and the crystallization of large, mainly implicit, government liabilities to the financial sector.¹⁴ To paraphrase Rajan (2010), public finances were also sitting on *fault lines* largely because governments had substantially underestimated the risks to their fiscal prospects. Finally, the sharp deterioration of the fiscal stance that accompanied the crisis and the related need for fiscal adjustment have increased the incentives for governments to engage in activities that cloud the true state of their finances. As argued in quite a few chapters of this book, much remains to be done in this area because fiscal reports can be manipulated, thus circumventing fiscal rules and objectives.¹⁵

¹² Positive causality between the quality of budget institutions and fiscal outcomes has been demonstrated in numerous studies covering countries with different income levels, constitutional systems, and geographical locations. See, for example, von Hagen (1992); von Hagen and Harden (1996); Alesina and others (1999); de Haan, Moessen, and Volkerink (1999); and Debrun and others (2008).

¹³ Although well beyond the purposes of this book, it may not be sheer coincidence that the debate on the role of institutions in generating growth and alleviating poverty has been reinvigorated in the last few years. See, for instance, Acemoglu and Robinson (2012) and the comments it has generated by, for instance, Sachs (2012) and Diamond (2012c).

¹⁴ Although not explicitly discussed in this book, fiscal transparency—defined as the clarity, reliability, frequency, timeliness, and relevance of public fiscal reporting and the openness to the public of the government's fiscal policymaking process—is a critical element of and permeates effective modern fiscal management.

¹⁵ Irwin (2012) discusses accounting devices and fiscal illusions in the wake of the crisis.

STRUCTURE OF THE BOOK

This book is divided into four parts. Its organizing principle is described by Schick in Part I, *An Overview of Contemporary Public Financial Management Reforms*. He draws a distinction between the different categories of innovations. The first category is major innovations that have introduced new or reinvigorated ideas and initiatives into PFM and that focus on specific issues such as the management of fiscal risks. The second category comprises reforms to the basic supporting PFM infrastructure, for example, accounting and budgeting frameworks. Modernizing this supporting infrastructure is important for providing the information and capacity to successfully implement the major innovations. This is echoing to some extent a back-to-basics theme often heard in many debates on PFM reforms in advanced as well as in developing contexts.

Accordingly, and following the architectural theme of this book, Part II discusses *Designing and Building: PFM Innovations and Reforms*. Part III focuses on *Strengthening the Foundations: Modernizing the PFM Infrastructure*. Part IV, *Adapting to the Environment: PFM Reform in Developing Countries*, brings to the fore selected aspects relevant particularly, but not exclusively, to designing PFM reforms in developing countries.

Part I. An Overview of Contemporary Public Financial Management Reforms

In the overview chapter, “Reflections on Two Decades of Public Financial Management Reforms,” Schick promotes a better understanding of how PFM innovations operate, how they interact with each other, and how they can be integrated into a comprehensive PFM structure. This chapter provides an original framework relating innovations to the three key PFM objectives and to three common levers or instruments—new information, process adjustments, and restrictive rules—used by reformers to achieve their objectives. The first two levers operate through changing the incentives and the behavior of politicians and public servants and the third by imposing restrictions on actions and decisions.

The chapter uses this framework as a lens through which to assess the major innovations and supporting reforms that are discussed in detail in Parts II and III. New information is essential for nearly all major innovations. Information on fiscal risks, evaluations of programs, and projections of debt and deficits can provide politicians and managers with new perspectives and motivate them to change existing policies. Schick argues, however, that in most cases information alone is not sufficient to influence behavior.

Politicians and managers are less likely to disregard new procedures than new information. The main issue is whether the new procedures will change behavior or become just another task that managers must complete. For example, a procedural requirement to include performance information in budgeting and

management processes can be used by managers to improve results or it can be seen as another technical requirement with little impact on decision making.

When the first two levers do not work, preferred procedures may be codified into rules, such as fiscal limits on debt or deficit, that constrain government actions. Rules have several advantages, the most obvious being that they cannot be disregarded as easily as new information and permissive procedures. Nevertheless, to work, rules have to build on innovations in information and process and not be a substitute for them.

Schick stresses that a government should apply constrictive rules only when it has a good understanding of why enhanced information and processes do not work. He cautions that not every procedure should become a constraining rule because it may end up limiting the discretion of democratically elected leaders, introducing rigidity into the PFM system, and becoming an end in itself rather than a means to an end.

The chapter concludes the discussion on levers by acknowledging that there is no “automatic transmission belt” that converts levers into modified behavior and changed behavior into substantive outcomes. PFM is an open system exposed to many economic and political factors that affect incentives and behavior of politicians and public servants. Therefore, this chapter and this book stress the importance of a country’s underlying political and administrative culture and institutions and the role of political and managerial leadership in successfully implementing reforms.

As the 2008–09 crisis emanated from the financial sector, PFM has largely been a bystander since the onset of the crisis and during its initial stages. The real test for PFM was in the precrisis years in which, Schick argues, some innovations did not yield the expected results. Under unfavorable economic conditions, spending was increased to stimulate the economy, but when conditions were more favorable, spending was not lowered. In sum, in good times governments did not save. The average gross public debt-to-GDP ratio for the Group of Seven nations rose from 35 percent in 1974 to more than 80 percent in 2007, just before the crisis (Cottarelli and Schaechter, 2010). Schick concludes that PFM can make a difference to fiscal and budgetary outcomes, and the still-emerging lessons from the crisis about PFM innovations can improve them and contribute in the future to averting or at least better managing the next crisis. Key among the lessons is the need to redesign fiscal rules and improve fiscal risk management to look beyond the government sector.

Part II. Designing and Building: PFM Innovations and Reforms

Chapters 2 through 6 examine different innovations—fiscal responsibility legislation, numerical rules, MTBFs, fiscal risk management, and independent fiscal agencies—that concentrate on promoting fiscal responsibility. Although the objective is the same, different levers and approaches are used. Chapters 2 and 3 focus on codifying procedures and rules. MTBFs, discussed in Chapter 4, seek to

contribute not only to fiscal sustainability, but also to the two other PFM objectives of effective allocation of resources and efficient delivery of services, and can use all three levers—new information, changing procedures, and rules—to influence behavior. Chapters 5 and 6 emphasize fiscal sustainability and the role and importance of information and analysis. Performance budgeting and information, covered in Chapter 7, are expected to contribute to the goals of effective allocation of resources and efficient service delivery. Performance budgeting relies on new information and changes in procedures to improve performance.

Van Eden, Khemani, and Emery explore in **Chapter 2** how fiscal responsibility laws (FRLs) can support more sustainable and transparent fiscal policies. Since the 1990s, there has been a significant growth in the number of countries that have developed fiscal responsibility provisions, which embed in law an agreed-on set of arrangements intended to promote fiscal discipline, transparency, and accountability. This chapter argues that design choices are critical to the success of FRLs and explores different design options. In designing FRLs it is important to start with modest and flexible frameworks then gradually move to more prescriptive legal requirements for fiscal policy. Building up PFM capacity is an additional reason to take a gradual approach. The more complex the law, the greater the capacity needed. This chapter concludes that FRLs, in conjunction with the other innovations discussed in this section (MTBFs, a new generation of numerical fiscal rules, and independent fiscal councils), can play an important role in strengthening fiscal outcomes. When adopting these laws, however, reformers should not stride too far ahead of societal acceptance and recognition of the importance of fiscal sustainability.

In **Chapter 3**, Budina, Kinda, Schaechter, and Weber take stock of the development and use of numerical fiscal rules—long-lasting constraints on fiscal policy through the application of numerical limits on budgetary aggregates. This chapter provides a systematic compilation and comparison of numerical fiscal rules and their design elements. In particular, it reviews trends—from the mid-1980s through early 2012—in the types and number of rules, as well as their combinations and main characteristics. This review includes discussions of the legal bases, enforcement, coverage, escape clauses, and provisions for cyclical adjustments. The chapter also examines the next generation of fiscal rules emerging in the aftermath of the 2008–09 global economic and financial crisis. To be effective, it is important that rules be an integral part of the budget formulation and execution cycle and have the necessary supporting institutions. Despite widespread application, fiscal rules are not without challenges, including relative rigidity in adjusting to shocks and the potential to generate incentives for creative accounting. The next-generation fiscal rules, which are attempting to address some of these issues, tend to be more complex, thus creating new challenges in design, implementation, and monitoring. Given their relatively high degree of complexity, their effectiveness will also depend on country-specific institutional capacity.

A key issue in PFM is the inability of government to look beyond a one-year time horizon when making decisions on current or proposed policies and

expenditures that have fiscal implications for many years ahead. To help address this concern, over the last two decades more and more countries have developed MTBFs. Harris, Hughes, Ljungman, and Sateriale in **Chapter 4** define MTBFs as “a set of institutional arrangements for prioritizing, presenting, and managing revenue and expenditure in a multiyear perspective.” There is no single MTBF model. Countries have taken a range of approaches. Preconditions for a successful MTBF include a credible and predictable annual budget, accurate medium-term macroeconomic and demographic projections, established fiscal objectives and rules, and a comprehensive top-down budget process. This chapter stresses the importance of design for success. Using original empirical research, it tests the impact of the different types of MTBF on fiscal outcomes and allocative efficiency. It also examines how selected MTBFs have been adjusted to help governments respond to, and deliver, both fiscal stimulus packages and fiscal consolidation.

The global financial crisis dramatically illustrated the importance of managing the fiscal risks to which public finances can be exposed. Budina and Petrie in **Chapter 5** assess the trends since the early 1990s toward more active disclosure and management of fiscal risks. They explore in detail how a fiscal risk management cycle tool can help governments identify, analyze, and incorporate risks into the budget, and disclose, mitigate, and monitor those risks. Since 2000 some progress has been made on disclosure of information on fiscal risks, and a few countries have developed fiscal risk statements. The IMF guidelines for fiscal risk management provide countries with risk disclosure and management principles. Although some countries have made advances, risk management for many others remains at a basic level. As the crisis illustrates, many challenges in improving risk management remain. Key among them is the lack of a systematic and centralized approach to identifying risk; simply put, many governments have no basic information on the range and magnitude of risks to which they could be exposed. The chapter concludes that in the wake of the crisis, the ability to identify and analyze risks has become more critical than ever. The priorities and capacities for strengthening risk management, however, will depend on individual country circumstances and conditions.

Another trend emerging since the crisis is an increased emphasis on independent scrutiny and analysis of governments’ fiscal policies, plans, and performance and the corresponding growth in independent fiscal agencies. Among these, fiscal councils are hailed as a mechanism for promoting fiscal responsibility. Hemming and Joyce, in **Chapter 6**, review the justification for establishing independent institutions and councils, the different roles and functions they perform, and the requirements for their success. Councils do not exercise influence through formal procedures or rules but by providing independent information and analysis that can influence policymakers and the public. The theory is that independent review improves fiscal transparency, which can, in turn, enhance fiscal discipline. Fiscal councils can be advisory bodies reviewing and commenting on government fiscal policies, and/or auditing bodies that verify the reliability of government information, including the quality of their forecasts. This chapter presents a number of

factors influencing the success of a fiscal council, including guaranteed independence, formal influence, political support, clear legal backing, and technically qualified staff. It concludes that although, in principle, fiscal councils can play a role in promoting fiscal discipline, it is too early to disentangle their impact on fiscal outcomes.

Curristine and Flynn in **Chapter 7** examine governments' continuous quest for improved public service efficiency and performance. Performance tools—performance management, measurement, and budgeting—have become an integral part of how governments do business. These tools all depend on performance information (PI) to measure, monitor, and improve performance. Nearly all OECD countries have developed PI and many have introduced procedures to integrate it into accountability, budgeting, and management processes. The issue is getting this information used in decision making. Information is not an end in itself but a means to better performance. In many countries it has proven more challenging to ensure the use of PI in budgeting than in management. This challenge arises from problems in aligning incentive structures, political economy issues, and informational and institutional constraints. This chapter also discusses how PI can be used in fiscal stimulus and consolidation, arguing that the approach to its use will depend on many factors, including speed and depth of consolidation, existing performance budgeting systems, the quality of PI, and the political willingness to use it. The chapter concludes by highlighting selected countries' experiences with spending reviews.

Part III. Strengthening the Foundations: Modernizing the PFM Infrastructure

Part III builds on one of Schick's themes—the critical role of information—by focusing on developments that have taken place in public accounting and reporting, cash and debt management, and public investment. It also sheds some light on accrual-based budgeting, a reform that only a limited number of countries have attempted. All the reforms discussed in this part contribute to all three PFM objectives. They are important for supporting the innovations discussed in Part II; for example, improving fiscal reporting supports better management of fiscal risks and enhanced transparency.

Blondy, Cooper, Irwin, Kauffmann, and Khan in **Chapter 8** examine the trends in fiscal reporting over the past decade. Government reporting on its fiscal position, whether in financial statements, fiscal statistics, or other documents, is vital to PFM and contributes to its three objectives. This information is essential for governmental decision making and for accountability. Significant changes have occurred in this area in the past decade. The comprehensiveness of reports has improved because many governments that in the past reported only cash flows and debt now report assets and liabilities. The adoption of accrual-based reporting has been motivated by the realization that cash reporting does not reveal costs in a timely manner, which in turn spurred the development of new accrual-based international statistical and accounting standards. Another important development is

the extension of coverage of reports beyond just the central government, to include local governments and more public entities in an effort to limit off-budget spending. Despite these developments, reporting before the crisis gave few warnings of the looming problems; the risk posed by the financial sector was largely ignored in fiscal reporting and statements. The crisis emphasized both the importance of fiscal reporting and the need for further improvements, including increased focus on government balance sheets.

Gardner and Olden in **Chapter 9** discuss how governments' management of their financial assets and liabilities has evolved since 1990. The chapter focuses on changes in how governments have managed their cash and debts during this period. Significant changes have been driven by the increased volume and complexity of financial markets, by innovations in information and communication technologies, and by new institutional designs and capacity building. There is also a greater awareness of the need to integrate the management of all government financial assets and liabilities. Increasingly, debt management offices have been given responsibility for cash management. This chapter argues for an integrated as opposed to fragmented approach to cash and debt management for a variety of reasons. Integrated management creates incentives to manage all government financial resources in a portfolio, avoids sending confused signals to the markets, and consolidates scarce resources by allowing streamlining of information technology systems and back-office facilities. In addition to discussing recent trends, this chapter examines current challenges and specific issues facing emerging and developing economies. It also addresses how countries that had already developed effective systems before the crisis have benefited from them during the course of the crisis.

Fainboim, Last, and Tandberg in **Chapter 10** examine the changes in public investment management during the past 20 years. Even before this period, the management of public investment had undergone noteworthy changes. Against a global decline in public investment, the authors observe the abandonment of national plans and planning ministries in advanced economies in favor of decentralizing this function to sector ministries and the elimination of dual budgeting. The chapter considers how some of the PFM innovations discussed in Part II of this book, including MTBFs and performance budgeting systems, have affected the way that governments manage their public investments. Despite the mainstreaming of public investment into government management and budgeting, its unique nature still requires some specialized tools. This chapter discusses selected new and revamped public investment management tools. It also addresses changing approaches to financing public investment, concentrating on public-private partnerships and highlighting the importance of understanding and managing the risks created by these contracts. Public investment management and planning has significantly benefited from PFM innovations. However, despite these benefits, procyclicality and the stop-and-go nature of public investment persist, as made evident during the crisis.

Khan in **Chapter 11** discusses accrual budgeting. Although many governments have introduced accrual accounting, only a few have adopted accrual

budgeting. These are countries that already produce ex post financial reports for central government on an accrual basis. No single model of accrual budgeting exists. Countries have adopted different frameworks suitable to their country contexts. This chapter examines why accrual budgeting can be a useful reform and how it works in practice, and notes the different country approaches. This chapter considers the potential benefits and challenges of accrual budgeting, along with the prerequisites for successful implementation. Among these prerequisites are a phased approach to implementation, political support, a sound cash budgeting system, and technical capacity.

Part IV. Adapting to the Environment: PFM Reform in Developing Countries

Although much of the focus of this book is on advanced economies, this part explores issues and challenges in implementing PFM reforms in developing countries. It stresses the importance of adapting PFM innovations to the environment and individual countries' contexts and capacities. Each of these chapters discusses the sequencing of reforms, the impact of context and differing institutional and technical capacities, and the influence of political economy factors on PFM reform prospects in developing countries. These considerations also apply to advanced and emerging economies.

Fedelino and Smoke in **Chapter 12** examine an underresearched topic: the links between PFM and decentralization reforms. Conceptually, the link between these reforms is strong and mutually beneficial. In practice, however, this link is rarely established. Decentralization reforms and PFM reforms are often formulated as independent initiatives managed by different agencies with different goals—thus, uncoordinated and not sequenced. This lack of synchrony creates inconsistencies in government systems and operations and sends mixed signals to key actors. This chapter argues for more integrated analysis and better coordination in the development and execution of PFM and decentralization reforms. It emphasizes the importance of more systematic and formal analysis to help reformers understand the implications of country context for the links between PFM and decentralization.

In **Chapter 13**, Dabán and Héris explore how well-designed and sequenced PFM reforms can help natural resource-rich countries manage their public finances and avoid the resource curse. This chapter asserts that weak institutions in the preresource period, combined with poorly designed, opaque, and rigid resource-specific operational mechanisms, have contributed to the curse in some countries. The few countries that have successfully avoided the curse already had strong institutional and PFM systems in the preresource era. Resource-specific mechanisms, when poorly designed, can reduce the efficiency of government spending and result in fragmentation and delay in the budget process. By explaining the unique challenges of managing finances in natural resource-rich countries, this chapter develops a PFM framework and sequenced reform path for these countries, seeking to enhance rather than replace or

bypass existing budgetary institutions so as to preserve the integrity of the budget process.

Finally, Allen in **Chapter 14** presents an analytical perspective on the current debate about the challenges of reforming budgetary institutions in developing countries. The chapter explores the factors that determine the development of budgetary reforms and what can be learned from advanced economies about prioritizing and sequencing reforms. Advanced-economy experience shows that reforming budget institutions is a very slow and challenging process, closely related to wider societal, political, and economic institutional developments. Further complications are that reforms require a willingness on the part of politicians to make hard choices; incentives for reform among politicians and public servants are weak; ministries of finance tend to be weak; and fragmented budgets are a common problem. This chapter asserts that transplanting advanced-economy approaches to reforming budget institutions into the alien environment of developing countries is likely to be unsuccessful. Although there are some exceptions, they are rare. The chapter argues that the more successful improvement strategies have a relatively short time horizon, focus on narrow and specific objectives, and involve a large element of trial and error.

WHERE DO WE GO FROM HERE?

In line with the leading theme of this book—the emerging architecture of PFM reform—this section refrains from providing any firm conclusions. The hope of this book is instead to distill a number of considerations for decision makers, international public finance specialists and practitioners, and the public at large.

- Modern PFM comprises a set of increasingly complex processes, rules, systems, and norms that are intrinsically linked to one another. Heated discussions on individual innovations often ignore this simple tenet and confuse the trees with the forest. Every reform needs a champion but very few champions have the vision to see how each innovation is interconnected with others and how only a harmonious assembly of all the bits and pieces has the chance to ultimately provide the answers and solutions sought.
- The relative emphasis on PFM's three key objectives—maintaining a sustainable fiscal position, effective allocation of resources, and efficient delivery of public goods and services—has shifted from the effectiveness and efficiency arguments to fiscal sustainability. Once again, these three objectives should not be addressed in isolation. For a long time, however, the sustainability aspect was neglected, with the obvious result that a string of “good years” was wasted with no strengthening of fiscal positions while precious time and resources were invested in other—and with the annoying benefit of hindsight, arguably less important—aspects of PFM.

- The importance of the particular context—historical, political, and geographical, but also human capital—in which a country decides to manage its public finances better cannot be stressed strongly enough. There are no magic bullets or cookie-cutter approaches to strengthening PFM, and any attempt to import innovations that may have worked elsewhere should be carefully assessed and subjected to an “on-the-ground” reality check. The same applies to political economy considerations and reforms aimed at addressing more systemic public administration or governance aspects.
- The importance of information also cannot be overly stressed. In still too many instances, countries have been caught by surprise because the coverage—either of institutions or of transactions—of fiscal activities was not fully captured. The focus is not only on past and current fiscal developments, but even more forcefully on future developments. The progress made on reporting standards is part of the effort to define better ways to convey an accurate picture of public finances for various purposes, from aggregate demand management to accountability.
- Related to the point above is the current emphasis on extending the horizon of fiscal policy by adopting medium- to long-term frameworks aimed at making clear the impact of today’s policy decisions on tomorrow’s outcomes. A better appreciation of fiscal risks—in a nutshell, all factors that can explain outcomes different from planned—has now been widely accepted, although the practice is still lagging.
- Information can also be a double-edged sword. Although it has to fulfill many purposes, including international comparability, actors are always tempted to make information an end in itself instead of a means to help policymakers design and implement the best responses to society’s needs. Numerous examples of information overload have proved frustrating to those involved in its production and those incapable of making good use of it. Information alone may in many cases not be sufficient to change key actors’ behavior.
- A plethora of discussions, theories, and approaches to the sequencing of PFM reforms have arisen since the mid-1990s. We may have come full circle with the obvious conclusion that “it depends on a number of country-specific factors.”¹⁶ “Basic first” seems to be the prevailing view at this stage, but it should not lead to oversimplification and a too-rigid approach; individual countries may occasionally leapfrog and make the most of available technologies and lessons from early reformers. External factors, most notably political economy aspects but also human capital, can help explain why reforms tend to take longer than initially planned and in many instances turn out not to be sustained over time, causing undesirable backsliding.

¹⁶ See Diamond (2012a, 2012b) and Tomassi (2012) for recent work on development of a guidance note for sequencing PFM reforms in the context of the OECD Development Assistance Committee, and Schick (2012).

Viewing PFM as an integrated framework and taking account of the considerations discussed above are essential in the wake of financial and economic crisis and, possibly, in trying to prevent the next one. As is often the case, however, it may be necessary but not sufficient. Bringing about a paradigm shift whereby responsible and accountable policymakers make decisions taking account of long-term considerations and the implications for the entire public sector on the basis of the best available ex ante and ex post information may require more than full implementation of the innovations discussed in this book. We should not forget, however, that many of them remain to be adopted or fully absorbed by most countries. This is therefore the agenda for the immediate future. Nevertheless, if the past provides any lessons, other innovations will come along to strengthen PFM's emerging architecture.

Finally, does this book provide an architectural design for modern PFM? We hope so. As noted at the outset, the objective is to identify PFM's constituent elements, along with a number of considerations that should be taken into account in designing the PFM framework most suited to addressing the needs of a particular society. Going beyond that would be pretending to have discovered a magic formula that does not and cannot exist. In assembling some of the innovations discussed in this book, the ultimate design will have to take into account individual countries' specific contexts and the need for flexibility to adapt to sudden changes in circumstances. Architects and engineers have learned over the years to design buildings that can withstand earthquakes, so future PFM frameworks will be well equipped to manage public resources when facing increasingly strong tremors. We are getting there; we are just not there yet.

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