

# **Public Financial Management: Planning and Performance**

## **Unit 1 The Contexts of Public Financial Management**

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## Unit Overview

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 legal framework within which budgeting is done
- the changing nature of accountability in the public sector.

The relevant context of budgeting 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 its 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 a 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.

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 your study of this unit, you will be able to:

- outline and discuss the broad macroeconomic foundations of public fiscal policy
- summarise the institutional context of budgets
- define accountability in the public sector.



## Reading for Unit 1

Richard Hemming (2013) Chapter 1: 'The macroeconomic framework for managing public finances', in *The International Handbook of Public Financial Management*: pp. 17–31.

Ian Lienert (2013) Chapter 3: 'The legal framework for public finances and budget systems', in *The International Handbook of Public Financial Management*, pp. 63–83.

## 1.1 Introduction

This module is about three main issues:

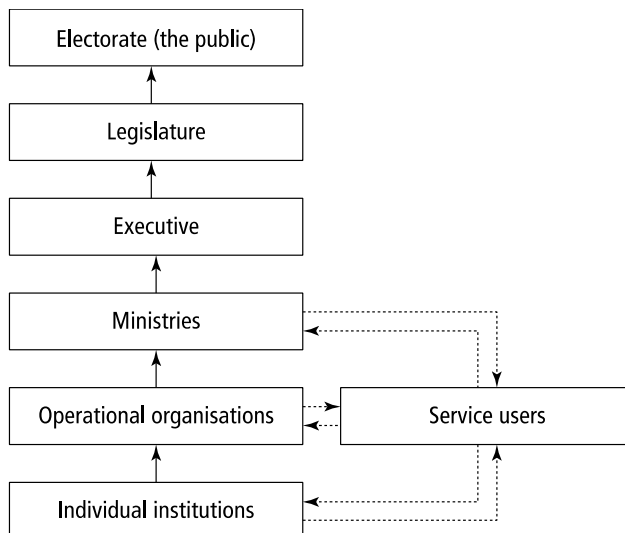
1. How budgets are written, including how costs are calculated and how budgets are constructed.
2. Public accountability through the publication of financial accounts.
3. The management of resources and the contribution that financial management can make to the performance of public services.

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 module 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 and formal approval by legislatures, and consultation with 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 decentralised 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.

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## 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.

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### Exercise 1.1

Write down your understanding of a budget and its purpose.

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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 (or specified planning period) ahead
- help with planning and making choices among priorities
- coordinate 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 is increasingly 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.

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 **Exercise 1.2**

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 module.

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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.

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## 1.3 The Macroeconomic Framework

### Fiscal policy and public financial management (PFM)

The biggest influence on how much can be spent in any planning period is how much the government can afford. Spending can be financed by the money raised from taxation and other revenues, such as the sale of oil or licences, by 'printing' money and by borrowing. 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, governments are more willing to run deficits. During economic boom times, governments are more able to run surpluses when they collect more buoyant taxes. The banking crash and consequent fiscal crisis of 2007+ created a rethinking of the use of fiscal policy in economic management: on the one hand were the international financial institutions, such as the World Bank and the IMF who proposed the restoration of fiscal stability through fiscal rules (IMF, 2009); on the other were governments faced with a combination of recession and unemployment and poor prospects for tax revenues. In Europe, most governments were faced with unplanned deficits. Countries that borrowed to maintain some of their public services had fiscal rules imposed by their borrowers. The fiscal instability lasted a long time and changed attitudes towards what is a sustainable deficit, and what is an acceptable level of government debt. The OECD (2010) conducted a survey of responses to the fiscal crisis.

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### Optional Reading 1.1

If you have time, you may wish to read the OECD (2010) survey of responses to the fiscal crisis. However, this is an optional reading and you will not be examined on it.

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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 other initiatives, 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 distin-

guish 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.

This module is concerned with PFM rather than macroeconomic policy<sup>1</sup>. However, the interaction between the two can be an important influence on public financial management. For example, governments may try to reduce the fiscal deficit for macroeconomic reasons by reducing expenditures. PFM is then directed towards finding spending cuts, whether by increasing efficiency, reducing eligibility for services, reducing the volume of services provided or simply cutting out programmes.



### Reading 1.1

Please turn to *The International Handbook of Public Financial Management* and read Chapter 1 by Hemming up to page 31.

The links between fiscal policy and PFM are set out very clearly in Table 1.1 which shows fiscal instruments, and what is required of the PFM system to enable those instruments to succeed. The table is reproduced here:

Hemming (2013)  
Chapter 1 'The macroeconomic framework for managing public finances' in Allen *et al* (Eds.) *The International Handbook of Public Financial Management*.

**Table 1.1 Links between fiscal policy and PFM**

Fiscal policy objectives	Fiscal management instruments	PFM requirements
Aggregate fiscal discipline and macroeconomic stability	Medium-term fiscal framework	Revenue forecasting capacity Comprehensive budget Internal control
	Fiscal rules	Accounting and reporting standards Effective monitoring
	Fiscal transparency	Annual fiscal policy statement Citizens' guide to the budget Timely fiscal reporting
	Fiscal risk control	External Audit Disclosure of non-debt liabilities
Spending efficiency and sustainable growth	Medium-term budget framework	Top-down and bottom-up budgeting process Unified current and capital budget
	Public investment planning	Project appraisal capacity Public-private partnership guidelines Asset management strategy
	Performance budgeting	Program-based budget classification Performance monitoring system

Source: Hemming (2013) p. 19.

<sup>1</sup> The CeFiMS module *Macroeconomic Policy and Financial Markets* is about fiscal policy.

If you are studying for the MSc or Postgraduate Diploma in PFM you will become familiar with all the elements in the PFM requirements column. In this module we are concerned with those elements that relate to budget planning and execution, including performance budgeting, and accountability.

You should note that the author is sceptical about the effectiveness of counter-cyclical fiscal policy, using debt-financed expenditures to increase aggregate demand when an economy has spare capacity or is in recession. He is also pessimistic about the possibility of predicting what is a sustainable level of debt. Not all economists share this view, nor do all governments.

What you should take from this chapter is how the technical components of a PFM system have been developed in response to the development of fiscal policy instruments.

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## 1.4 The Legal Framework


The second element of the context that shapes PFM is the legal framework within which it operates. There is a large variation in legal frameworks among countries, depending on their history of state formation, constitution and political practices. Often there is a residue of colonial practices in ex colonies.



### Reading 1.2

All countries have Budget System Laws that set out the legal framework for the budget process. Chapter 3 of *The International Handbook of Public Financial Management* by Ian Lienert sets out how these laws vary around the world. Please read Chapter 3 now and note the variations (pp. 63–83).

Lienert (2013) Chapter 3 'The legal framework for public finances and budget systems', in Allen *et al* (Eds.) *The International Handbook of Public Financial Management*.

 Now, please investigate the legal framework where you are currently working. Make a summary and post it to the VLE. Make sure you answer the following questions:

1. What is the relationship between legislature and executive with regard to budget decision making?
2. Is it a federal or unitary state? What is the distribution of powers among the tiers of government?
3. What are the arrangements for the accountability of the executive to the legislature?
4. Are there fiscal rules, for example, on the maximum permissible deficit?
5. Does the budget law specify that all public expenditure, including state corporations and parastatal organisations, is covered by the budget?

Once everybody has posted their summaries, your tutor will initiate a discussion on the differences and the reasons for them.

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## 1.5 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 above.

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 those 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 are 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.

In a more managerial system of public administration, the accountability assumptions are based on controlling inputs and outputs and, in some cases, outcomes 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 outcomes must be linked to outputs and 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.

### **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.

The implication for managers is that they have more responsibility for results, compared to an administrative system. The only problem with the shift in emphasis is that the cash involved is still public money and still needs to be accounted for. Freewheeling 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.

### **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. 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 exists 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. There has certainly been an increased use of financial incentives in various countries' public sectors 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. A more managerial approach 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 into 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, and in many other jurisdictions.

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## 1.6 Conclusion

This unit has examined the impact of the context on how budgets are produced and managed. Changing fiscal conditions have induced technical changes to elements of the budget process. The second context we looked at was the legal framework established by budget system laws. The legal framework sets out both the requirements and the constraints of the laws relating to the budget. Finally, we looked at the changing nature of accountability, with a shift in emphasis from a simple accountability for resources consumed to accountability for efficiency and performance.

In the next unit we turn to the coverage, classification and structure of the budget.

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### Exercise 1.3

Check that you can define the following terms:

- fiscal stance
- budget system laws (BSLs)
- federal and unitary state
- executive and legislature
- accounting
- inputs, outputs, outcomes
- cash accounting
- accruals accounting.

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## References

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