

The Four Dimensions of Public Financial Management

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Introduction

In all of the discussion of Public Financial Management (PFM) and conceptual frameworks for financial reporting, there has been only limited discussion of the objectives of public financial management.

Campos and Pradhanⁱ identified three objectives of fiscal management: aggregate fiscal discipline; strategic prioritisation of expenditure and technical efficiency. Allen Schickⁱⁱ has identified three different objectives of public budgeting: Strategic Planning; Management Control and Operational Control. Both of these approaches tend to focus on the budget, but in fact this is only one aspect of PFM.

By way of contrast, the International Public Sector Accounting Standards Board (IPSASB) approaches from the perspective of published financial statements. The IPSASB Consultation Paper considers a conceptual framework for financial reportingⁱⁱⁱ and identifies two objectives for financial statements: accountability and resource allocation.

The IPSASB approach views PFM as an information system; but it also a purposive system, e.g. it does not merely provide information on expenditure but actually manages and controls such expenditure. The Chartered Institute of Public Finance and Accounting (CIPFA) has recently produced a consultation draft on a whole systems approach to public financial management^{iv} which considers PFM as a purposive system: *“Public financial management is the system by which financial aspects of the public services’ business are directly controlled and influenced to support of the sector’s goals”*. The CIPFA model includes a list of goals, or objectives, for PFM. These are defined as *“sustainable social benefits”* which are sub-divided into:

- Funder results
- Public value
- Community value
- Individual value.

Unfortunately the CIPFA draft does not further explain these concepts. However, they do suggest that whilst CIPFA defines PFM in terms of financial aspects, the target objectives are more concerned with delivering a range of benefits for civil society. Certainly they appear very different to any of the other PFM objectives defined above.

What the above approaches indicate is that any attempt to define PFM objectives in terms of a single approach is too narrow; instead PFM should be seen as an information and a purposive system with multiple objectives which can usefully be viewed as a series of dimensions.

This article suggests that the objectives of PFM can be viewed as having **four dimensions**:

Dimension 1 – aggregate fiscal management

Dimension 2 – operational management

Dimension 3 – fiduciary risk management

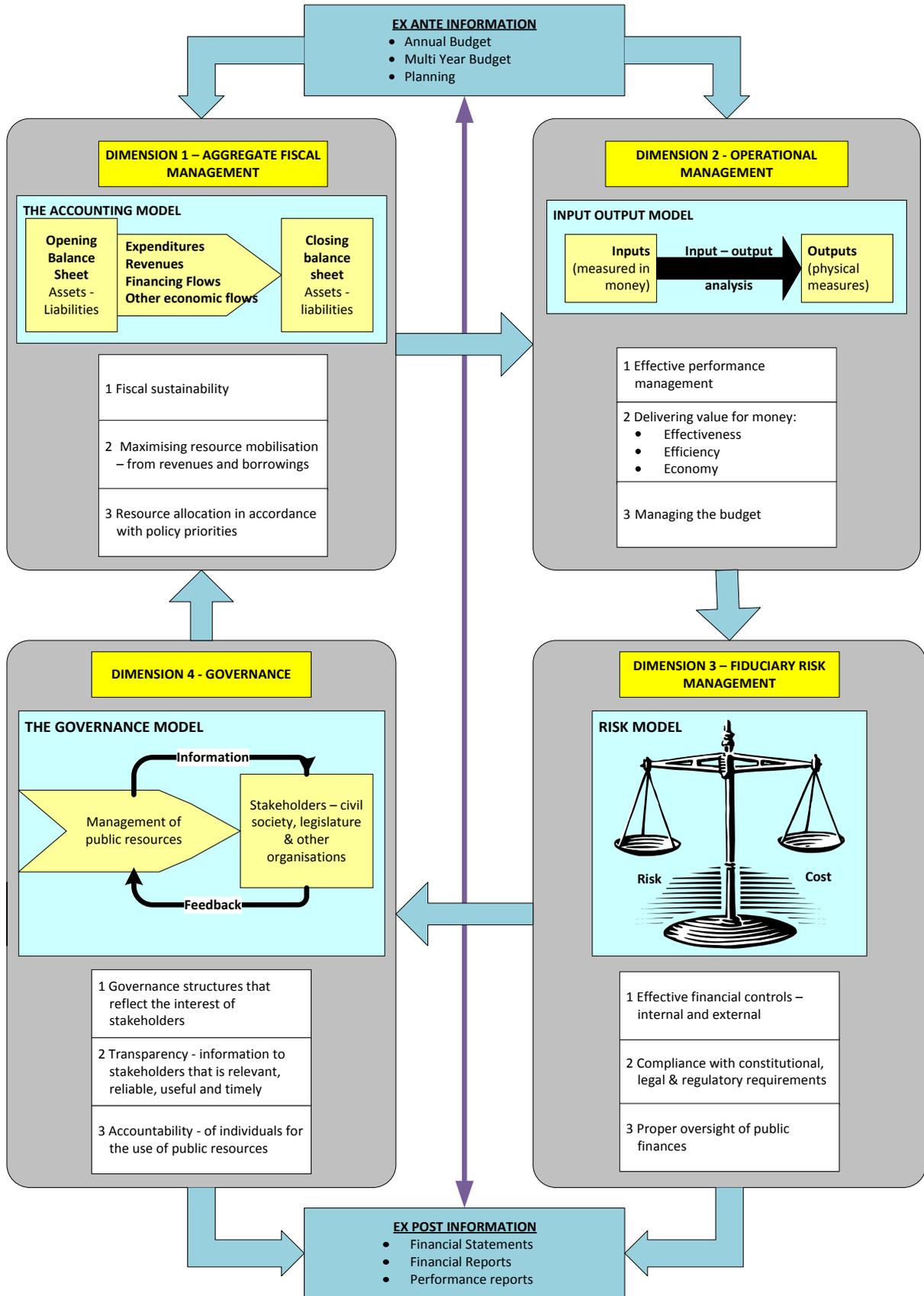
Dimension 4 – governance

Furthermore each of these dimensions is reflected in public financial management as an information system providing both ex ante (budgets, plans) and ex post (financial statements, performance and other) reporting.

Each of these four dimensional, a primary set of target objectives and the link to the information systems are summarised in the diagram on the next page. The rest of this article reviews each of these dimensions and the objectives within the dimensions. The dimensions are approached in the context of national government, but most of the comments can be transposed to sub-national public sector organisations. However, this model is proposed as a framework for identifying objectives rather than a definitive statement of all possible objectives of all aspects of public financial management.

It should also be noted that this model does not conflict with any of the definitions of objectives for PFM above. Rather, each of these can be seen as target objectives within certain dimensions; in fact as sub-sets of the whole PFM model.

The four dimensions of public financial management



Dimension 1 – aggregate fiscal management

A fundamental requirement of every government is to manage its finances at the aggregate level. The accounting model represents the financial flows and resultant balance sheets and hence provides basis for monitoring, controlling and ultimately managing public finances. Three specific objectives of aggregate fiscal management are identified:

1. Fiscal sustainability

One of the most fundamental responsibilities for any entity is aggregate fiscal management so as to be able to fund its activities from revenues and borrowings whilst remaining solvent – the objective of fiscal sustainability. For many countries achieving fiscal sustainability has become an increasing challenge over the last two years when faced with bailing out major financial institutions. This in turn has posed new issues of aggregate fiscal management of sovereign entities and the implicit guarantees made by such entities in respect of their banking sector. Sovereign entity debt is being “rated” in the same way as commercial entities on the basis of their balance sheet and future cash flows.

Fiscal risk is the problem of potential liabilities which do not at any point in time amount to actual liabilities, but may under certain conditions “crystallise” and become real liabilities. Financial reporting has for many years recognised these as “contingent liabilities” and required information on such contingent liabilities to be managed and reported. The obvious example are loan guarantees, e.g. on the loans of public enterprise, which will crystallise into actual liabilities if the borrowing entity fails to meet its loan obligations. But for governments the problem is more complex because of “implicit” guarantees, i.e. obligations not spelt out in law but which exist in reality – the obvious recent example is the obligation of governments around the world to bail out failing banks. This represent a huge fiscal risk that most governments did not even realise existed. Identifying and reporting such implicit fiscal risk is a major challenge for accountants.

Another newly recognised issue is the concept of a “structural” fiscal deficit, where current levels of revenues for some rich countries are inadequate to sustain levels of government expenditure, and choices have to be made between borrowing, increasing taxation or reducing expenditure. This problem will become more acute for many countries with aging populations. These issues in turn raise problems of inter-generational transfers.

These are not just PFM problems, but accounting provides the only comprehensive model of the relationship between entity revenue and expenditure flows and balances. Traditionally aggregate fiscal management has focussed on the budget and levels of borrowings. But in the future governments require more sophisticated tools taking better account in addition of fiscal risk, equity between social groups, inter generational transfers, and the closer monitoring of fiscal outturns. This must require increasing and more sophisticated use of PFM tools at the sovereign government level.

2. Maximising resource mobilisation

Almost all entities are constrained by limited financial resources. PFM has an objective in managing resource mobilisation within policy fiscal goals. This can operate at several levels:

- Credible financial statements can impact on perceived sovereign debt risk and hence the capacity for and cost of borrowing. It is likely that in the future audited government financial statements will play an increasingly important role in assessing sovereign debt risk and hence in mobilising resources.

- Perceived strong public financial management will be a factor in encouraging both public and private inward investment. For poor countries this will include encouraging support from development partners.
- Also for poor countries, enhanced public financial management can be one element in improving the ability to absorb and utilise external aid, effectively increasing resource availability.

3. Resource allocation in accordance with policy priorities

As noted above, most governments are constrained by financial resources and need to allocate limited resources to optimally achieve policy objectives. Resource allocation is at the heart of the budget planning process, and developments such as medium term budgets are attempts to more effectively link budgets to policy objectives over a time frame longer than the traditional annual budget.

It is tempting to see public financial management as “policy neutral”, i.e. providing the mechanism for implementing whatever policies a government adopts with no responsibility for the policies. But such a view is naive. By deciding what to measure and how to present information, the accountant influences policy decisions. For example, a budget that identifies the poverty or gender impact of expenditure will influence the allocation of resources to address such issues. On the other hand a budget can hide a particular category of expenditure, e.g. military spending, by spreading such expenditure over a number of budget items without specific identification.

Hence decisions about budget allocations and the key policy focus are intertwined with decisions about budget and financial statement classification, identification and presentation. Furthermore the effectiveness of civil society participation, in Dimension 4 below, is dependent on the transparency with which information is presented and resource allocation decisions identified.

PFM through the budget process should provide a mechanism for linking policy objectives with the constraint of financial resources. However, whilst the objective of resource allocation in accordance with policy priorities seems simple, it is in fact difficult to achieve because of the problem of articulating policy priorities, the interdependence between the measurement system and the identification of priorities, and the difficulty of making reliable forecasts extending several years into the future.

Dimension 2 – Operational management

Financial management has a significant role in the operational management of the day to day activities of government.

1. Effective performance management

A major constraint of PFM is that the accounting model of “not for profit” activities does not provide an input-output model for the public sector. Inputs can be expressed in money units, but outputs are typically service delivery. This contrasts with the commercial sector where accounting is a universal input-output model using a common measure of money. Inputs (costs) and outputs (sales) are measured in money units and the difference of profit, also in money units, providing a comprehensive basis for performance management. The development in the public sector of performance measures and management is an attempt to address the gap by developing non-financial measures of performance.

There is extensive literature on the techniques, problems and benefits of performance management systems. Performance management is often seen as a distinct discipline from PFM, but to be useful

performance measures of objectives must be linked to the financial resources used to achieve such objectives.

An objective of PFM must be an effective performance management system which links useful performance measures to the resources used to achieve the performance objectives.

2. Delivering value for money

The value for money objective could be seen as part of the overall performance management objective, but in fact it has a narrower perspective. Performance measures are concerned with achieving objectives. Value for money is simply a matter of ensuring that PFM contributes positively to delivering value for money, which in turn can be sub-divided into effectiveness, efficiency and economy.

In each of these areas it is possible to consider PFM as a system in its own right, and also PFM as a system impacting on broader management issues, as summarised in the matrix below.

Value for Money Criteria	The PFM system itself	Impact of PFM on rest of public sector
Effectiveness	Using the most appropriate PFM methodology and tools, e.g. appropriate use of automation	Measures and comparisons can identify opportunities to improve effectiveness
Efficiency	Ensuring funds for operations are available promptly when required	Information on budgets and resources available can enable efficient operations
Economy	Minimising transaction costs and delays	Ensuring minimal resources used to process transactions

3. Managing within the budget

The public sector is budget driven. Without a budget governments lack legal authority to raise revenues or to make expenditures. When a sum is allocated within a budget it is intended to be spent for the purpose indicated. Over spending is a regulatory issue that will have to be corrected either by reallocation or by a supplementary budget. On the other hand under spending represents a failure to utilise allocated resources. The objective of many public sector managers to spend the budget, neither more nor less, is in fact logically consistent with a budget driven process.

Thus for the public sector manager operating within the budget is a constant challenge, made more difficult by the constraint of an annual budget cycle. Managing within the budget requires timely information on budget allocations, commitments and actual expenditures. Hence an efficient budget, commitment management and accounting system providing timely and relevant reports is essential for budget management, which in turn contributes to the value for money objectives above.

Dimension 3 – Fiduciary risk management

A problem facing all entities is fiduciary risk – the risk of public money being stolen, used for purposes other than those intended, or used corruptly. There is a balance in fiduciary risk management between the cost of avoiding risks and the cost of such risks crystallising. PFM is part of the solution and provides important tools of risk management.

1. Effective financial control

The accounting system should provide a whole system of fiduciary controls, usefully summarised under European Union (EU) nomenclature as Public Internal Financial Control (PIFC). This comprises:

- Internal controls within an organisation, e.g. payment authorisation process, managing against budgets, reconciliation processes, and so on. These controls should be specifically designed to minimise the risk of loss.
- Internal audit – the oversight system established by the management of an organisation in accordance with international standards of internal audit

In addition external audit – the independent scrutiny by the Supreme Audit Institution of the activities of public sector organisations – provides an additional element of risk management.

All public sector entities should have in place a structure of internal and external controls so as to reduce fiduciary risk to acceptable levels. However, it also needs to be recognised that some risks extend beyond the financial system and will require other forms of control outside the ambit of PFM.

2. Compliance with constitutional legal and regulatory requirements

Typically governments operate within a rule bound environment. There is a hierarchy of regulation starting with the constitution and moving down through laws to the detailed financial rules, instructions and procedures. This bureaucratic structure is another element of fiduciary risk management and is designed to minimise the scope for activities which are not in accordance with public policy, i.e. to minimise fiduciary risk.

PFM both operates within this regulatory environment, and also itself acts as a system for enforcing the regulations. As with controls, there is a balance between the cost of bureaucracy and benefits in terms of ensuring consistency and further reduction of fiduciary risk.

3. Proper oversight of public finances

The last element of fiduciary risk management is oversight, particularly by the legislature. Typically a committee of the legislature, e.g. a “Public Accounts Committee” will review financial and audit reports of individual units within Government, e.g. Ministries, Departments. In many cases the review will be supported by technical staff.

The oversight process varies between countries, but typically will involve:

- Initial “desk reviews” by the Committee of financial information and audit reports
- Follow up meetings with key persons from the Government Ministry concerned, and/or with the auditors (which may be in public)
- Follow up actions.

An open and powerful oversight process can be a powerful tool in fiduciary risk management. It can lend power to the auditor, use parliamentary privilege to identify issues and make pronouncements and the mere existence of the system can be a powerful incentive for effective control procedures. At a sub-national level a similar system should exist through local government public account committees, audit committees and similar tools.

Dimension 4 – governance

The governance dimension has great significance in government because of the concept of government acting according to the will of the people. Whilst the people, i.e. civil society, are the primary stakeholder there will also be external stakeholders, e.g. lenders, multilateral organisations. Thus public sector governance has to meet the needs of all of these groups and at all levels of government.

1. Governance structures that reflect the interest of stakeholders

In theory a democratic government should reflect the will of the people and hence provides its own governance. In practice the most democratic systems put intervening barriers between public will and government policy, and specific mechanisms are required to overcome such barriers. The issue applies at national government and local government levels, and particularly to government agencies managed by unelected officials.

Governance issues can be addressed through a number of different approaches, e.g.

- Participation by stakeholder representatives, particularly in the management of unelected agencies.
- Ex-ante involvement in resource allocation decisions
- Ex post involvement in scrutiny and oversight (see above).

Governance is linked to PFM through the budget and financial reporting processes. Budgets are the ex ante resource mobilisation and management plans. Financial statements are the ex post reports on delivery. As such they are both tools in the governance process.

2. Transparency

Transparency is broader than financial information, but financial information will be an important part of transparent government. This includes all of published budgets, financial statements and audit reports as well as other financial information published by government.

As indicated above transparency is not just about providing data. The messages within the data must be made explicit; this requires judgments as to the appropriate messages, and hence the provision of relevant financial information. This is the same issue as noted above on budget allocations; there is an interdependent relationship between the information and judgments based on the information. Financial information will identify specific issues depending on the way it is classified and aggregated.

3. Accountability

Accountability goes beyond transparency and involves identifying individual responsibility for actions. Thus it can be seen as the end point of a participative and transparent process. Again accountability extends beyond accounting issues, but the latter will be a major element of the accountability process.

The level of accountability interacts with the basis on which budget holders are rewarded, and affects the level of central control that is necessary. Hence it has a profound effect on the design of the budget preparation, execution and accounting systems. PFM systems must have clear inbuilt assumptions about exactly how accountability will work – and they will need to be progressively redesigned as accountability improves. Therefore they must be either flexible or inflexible – an expensive inflexible system will hold up progress.

Information outputs

1. Ex ante information

Ex ante reports are the formal outcomes of the planning processes. They may comprise annual or multiyear budgets, or plans which extend beyond financial flows, e.g. sectoral plans based on “real” targets such as poverty reduction, health care, etc. The financial aspect of all such plans will embrace the four dimensions of objectives as defined above.

Ex ante planning reports will be specifically linked to the fiscal and operational objectives as reflected in Dimension 1 and 2.

2. Ex post information

For accountants the Financial Statements are a key ex post report. However, in the public sector the usefulness of purely financial reporting is limited because it provides no measure of service delivery and hence to be useful must be integrated with some form of performance reporting indicating how financial resources have been utilised to achieve “real” outcomes.

Ex post information will have a specific role in enabling the governance and fiduciary risk management objectives in Dimensions 3 and 4. Ex post reporting also provides a feedback loop to financial and operational planning.

Linkages

The whole model describes a single system of public financial management; as such all dimensions and objectives within dimensions are linked. But there are some specific linkages:

- Operational objectives depend on fiscal objectives, for example if funds are not available when required then operations cannot be conducted as planned and objectives will not be achieved.
- Fiduciary risk is the control over the operation of PFM as a purposive system executing a budget to achieve certain operational objectives.
- Governance in the PFM context is governance of the fiscal and operational objectives, and requires a system of fiduciary risk management as the basis for effective financial governance.

Some conclusions

The proposed four dimensional framework suggests that public financial management has a broad role in the whole public governance process. Furthermore specific sub-systems such as budget, financial reporting or audit, must be seen in the context of the overall four dimensional framework and their role within that framework. Hence the approach described in this article provides a basis for conceptualising specific areas within public financial management. For example general purpose financial statements can be seen as having particular relevance to:

- Dimension 1 – fiscal management
- Dimension 2 – particularly resource mobilisation
- Dimension 4 – governance.

Thus this objective analysis provides the basis for developing a conceptual framework for financial reporting.

Finally, it is recognised that this framework should be regarded as a first draft. Within the basic four dimensions there is scope to refine some of the sub-components, or even move them between dimensions. It may be that the dimensions themselves require further consideration. It is expected further discussion will refine and develop the framework as a useful analytic tool. What is important is the concept of public financial management as both a purposive and an information system with multiple dimensions and objectives.

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ⁱ “Budgetary Institutions and Expenditure Outcomes”, Ed Campos and Sanjay Pradhan, World Bank Policy Research Department, September 1996

ⁱⁱ “The Federal Budget: Politics, Policy, Process”, Allen Schick, 2007, Brooking Institute

ⁱⁱⁱ “Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities” International Federation of Accountants 2008

^{iv} “Public Financial Management and the PFM architecture – A Whole Systems Approach”, consultation draft, CIPFA, 20099