UNITED NATIONS

ST

Secretariat

Distr.
LIMITED

ST/SG/AC.6/1995/L.3
14 July 1995

ENGLISH ONLY

TWELFTH MEETING OF EXPERTS ON THE
UNITED NATIONS PROGRAMME IN PUBLIC
ADMINISTRATION AND FINANCE
New York, 31 July-11 August 1995

FINANCIAL MANAGEMENT FOR IMPROVED PUBLIC MANAGEMENT AND DEVELOPMENT*

CONTENTS

* Prepared by Mr. Graham Scott, consultant to the Department for Development Support and Management Services of the United Nations Secretariat; views expressed are those of the author and do not necessarily reflect those of the United Nations.

INTRODUCTION

1. The subject of the present paper, "Financial management for improved public management and development", is framed within the wider context of the special resumed session of the General Assembly on public administration and development. Accordingly, the focus is on financial management as a critical component of the total system of public administration and the role that it can play in implementing Governments' policies to promote national economic, social and other developmental goals.

2. The many alternative methods for public financial management and the mechanics of their implementation are not elaborated upon in the present paper; these technical topics are the subject of many excellent publications readily available in both developing and industrialized countries.

3. Further, it is recognized that each public administration has its own unique set of legislation and accountability requirements. Consequently, at the theoretical level no one method of public financial management will satisfy the specific needs of a government better than any other. It is only in practice that an optimal system of public financial management can be determined. The responsibility for making that practical determination rests squarely with each Government.

4. The approach taken in the present paper is to emphasize the role of public financial management in support of public administrative reforms that meet developmental needs; the individual system of public financial management and the different mechanisms and approaches by which that can be achieved, are not as relevant as the principles of public administrative reform that they help to put and keep in place.

5. The quality of any decision taken is entirely dependent on the nature of the information made available. It is well known that timely and reliable financial data guide the formulation of policy, and also initiate operational reforms; given the emphasis on reform in the present paper, that elementary point cannot be overstated.

6. In the absence of reliable financial data, decision makers are often compelled to rely on information that is outdated and incomplete or even anecdotal evidence when making crucial strategy determinations. This affects not only the quality of the decision that is reached most immediately but also the reliability that decision makers can place on their data sets, which serves

to undermine the confidence that policy makers have in the decision formulating process itself.

7. Where the reliability of data is suspect, the forward range of forecasts shorten and the scope of reform narrows into that area for which the data sets are accurate. At worst, reform is restricted to only those changes that will do the least damage in the event that the supporting data proves to be totally inaccurate.

8. By indicating that the availability of high-quality financial data is a decisive element in the process of public administration reform, the present paper alludes to one of the most elementary public reform issues that needs to be considered: how does a government establish a system to evaluate its financial management systems so that it can be fully familiar with the technical requirements of creating reliable data flows for its own use? As indicated earlier, the response to that question will be determined by unique issues at play in each country.

I. THE SCOPE OF GOVERNMENT FINANCIAL MANAGEMENT

9. The core of government financial management is generally taken to be budget planning and preparation, appropriation by the legislature, budget implementation, accounting and financial reporting; audit and evaluation is commonly but not always added to this list.

10. A description of public financial management can be found in many publications. The following descriptions are typical:

(a) Financial management is defined as encompassing all or part of the processes and functions of planning and programming, budgeting, budget execution and accounting, and audit and evaluation;

(b) The object of financial management is to ensure that, to the maximum practical extent, the resources entrusted to it are acquired and used lawfully, efficiently and effectively.

11. To be effective, this process requires reliable costing information from an integrated financial management process. The principles normally cited as a guide to financial management reform are:

(a) Use a structured planning and programming process for evaluating and choosing alternatives for achieving desired objectives;

(b) Make resource allocation decisions within a unified budget;

(c) Integrate budgeting and accounting;

(d) Use accounting principles that match the delivery of services with the cost of the services;

(e) Encourage financial accountability;

(f) Measure outputs as well as inputs;

(g) Prepare consolidated reports.

12. It should be emphasized that sound financial management requires a firm foundation in financial information, which can be achieved by establishing an integrated system of budget formulation, budget execution and accounting that focuses on the costs of past and future decisions.

13. The above-mentioned principles do not take into account the major contributions that a capable system of public financial management will bring to the processes of structural reform, organizational change, corporatization, or privatization. While financial accountability and measuring both outputs and inputs are encouraged, it is clear that such principles do not focus on a wider public administrative reform framework, based on performance incentives for the achievement of outputs and outcomes.

14. Notwithstanding the narrower scope granted by typical approaches to public financial management, the field is frequently identified as a key component within the wider systems of public resources management and policy formulation, alongside development programming and personnel and property management systems.

15. The integrated concept of public financial management is advocated in literature concerned with international development. Contemporary writings in this field take a similar view of the core of the public financial management subject, while focusing on issues of fiscal policy (in the sense of macroeconomic objectives of growth, stability and distribution), cash management, value for money auditing, efficiency in the provision of public services, and results-oriented financial management.

16. Recent publications in the area of public financial management concentrate

specifically on the questions of efficiency, effectiveness and results orientation, emphasizing the concepts of public resources accountability in pursuit of economic stabilization, economies in public expenditure, efficiency and effectiveness; by taking a very broad view of the role of public financial management and its potential contribution to public management and development, the present paper reflects the orientation of those publications.

17. Conceptual and practical advances in managing for performance in government have been made in the United Kingdom of Great Britain and Northern Ireland, Australia and New Zealand within the past 10 years or even earlier. For the past three years, there has been considerable effort in the United States of America to develop measures based on similar underlying philosophies within the national performance review.

18. The New Zealand model of managing for results is of interest in this field of contemporary public management practices and is elaborated on in section IV A below. The approach of the Government of New Zealand was to place particular emphasis on defining the outputs from government agencies, establishing personal accountability for resources used and measuring the full resource costs of producing public services.

19. Singapore, Malaysia and some Latin American countries are also implementing aspects of a results-based public resources management model; other States are assessing the concept. The model has also been described and evaluated by the Office of the Auditor General of the Government of Canada.

20. A key feature of this holistic approach to public management reform is that the critical issue of public financial management is integrated within but essentially subordinate to the main objectives of results-based management.

II. GOVERNANCE ISSUES AND PUBLIC FINANCIAL MANAGEMENT

21. Linking financial management with the wider issues of public management and development involves consideration of the political mandate and role of government, the processes by which its authority is exercised and its capacity for formulating and implementing policies. Collectively, those facets of government interaction with the civil society are referred to as governance issues.

22. The aide-mémoire for the resumed special session of the General Assembly on public administration and development focuses on the need for intellectual infrastructure, both human and institutional, to move from crisis management in

the public sector towards an enabling environment conducive to development. The aide-mémoire notes that significant responsibility for the creation of a competitive, dynamic and resilient economy rests with the public service. Indeed, it is agreed that the current widespread determination to improve governance structures and processes in the public sector is effecting rapid shifts in the scope and machinery of government. Within the context of reorienting government, the relationship between governance capacity and successful public administration reforms, particularly in the least developed countries and countries with economies in transition, must be examined.

23. There is evidence from around the world that poor governance undermines the prospects for improved prosperity in developing and industrialized countries alike. While it is an obvious point that a government's effectiveness is determined by what it chooses to do and how well it manages the implementation, it is observable in many countries that the Government assumes an expansive development role while failing to deliver reasonable levels of basic public services.

24. Governance structures and processes have a determining effect on the formation of national development objectives, the effectiveness of policy design and implementation efforts aimed at achieving them, the quality and availability of public services, the effectiveness and efficiency with which they are delivered, and even the legitimacy of the whole apparatus of government. The concept of governance spans this whole range of issues and provides a useful basis for reconsidering the scope and conduct of government. The World Bank, in its role as a multilateral funding agency, has identified three key aspects of governance: the form of political regime, the process by which authority is exercised in the management of the country's economic and social resources for development, and the capacity of Governments to design, formulate and implement policies and discharge functions.

25. Since the first aspect of governance is outside its mandate, the World Bank focuses its attention on the remaining two and reports on its governance activities under the following major headings, which are relevant to United Nations deliberations on this subject: public-sector management; accountability; legal framework for development; and transparency and information.

A. Public-sector management

26. Public-sector management and its reform is the major component of the governance issue, both conceptually and in relation to the efforts of international organizations in promoting improved governance. Public sector management is concerned with the civil service; the government budget; public investment; accounting; auditing and other financial management systems; strategic planning; programme evaluation; public finances, including aid coordination; economic management; the executive decision-making system; the structure of agencies; and the allocation of responsibilities. It also includes relationships between different levels of government and the framework for management of public enterprises and semi-autonomous government bodies.

B. The role of government

27. What is less often emphasized in discussions of governance is the importance of the role that the Government takes upon itself. The most profound improvements in public-sector management commonly arise from a change in the role of government, a phenomenon that is illustrated by the world-wide privatization movement that has emerged over the last 10 or 15 years.

28. By clarifying the role of the State and thus establishing that economic and social objectives could better be met by abandoning political management of business activities, a profound improvement in the performance of these activities can be achieved as governance principles in these countries change. The comprehensive privatization of State-run business in the Czech Republic illustrates this proposition.

C. The structure of government

29. Similarly, the structural reform of government activities, aimed at enhancing overall governance processes, can yield large improvements in public-sector management. Governmental reforms can improve the quality of policy and management by removing conflicts of interest, improving information flows and strengthening incentives for performance. Governmental reform can also promote a wider public interest in policy formulation, especially if the existing structure encourages undue influence from particular public or private-sector interests. Government structures also shape the accountability relationships between politicians, civil servants and the managers of public institutions. Accordingly, reforms to these structures will have an impact on the efficiency and effectiveness of public services delivery.

30. Examples of structural changes instituted in various Governments that have this impact are the separation of policy advice from organizations that administer those policies, and the separation of funding, purchasing and provision of services functions. The latter reform can be seen in various models of health and education reform. Establishing competitive sources of provision among public-sector providers and between them and private-sector providers can bring about major improvements in the price and quality of services delivered.

31. The design of a government's financial management system can have a major influence on whether competitive provision regulations, based on efficient and fair competition between suppliers, can be implemented. The typical government financial management system is cash-based and therefore does not reflect the non-cash resources that are being consumed, the amortization of State-owned fixed assets being utilized, or the future assets and/or liabilities arising from a government's current activities. Similarly, cash accounting does not include the interest costs of government-appropriated working capital, nor is the cost of taxation incorporated. Because costing developed under this approach does not reflect the real economic cost of providing goods or services by government agencies, there is a risk that competition between private-sector providers and their public service counterparts will be distorted in favour of the government provider. This outcome would undermine the ideal of competitive provision regulations, which is to source goods and services from those providers whose costs are lowest to the economy as a whole.

32. One possible remedy against this type of distortion is to apply generally accepted accounting principles, based on accrual accounting methods, to all government operations. This approach has been adopted by the Government of New Zealand, which applies international accounting standards to its government agencies as if they were private-sector entities. Capital charges are also levied, based on the equity reflected in a public institution's balance sheet. This is calculated as the equivalent rate of return on capital for a similar private-sector activity, adjusted to compensate for the non-payment of income taxes by public-sector institutions. All New Zealand public-sector agencies are required to pay indirect taxes. These policies result in full accrual accounting being applied to all government activities.

D. A typical reform agenda

33. The task of public-sector management reform is to promote the efficiency and effectiveness of those institutions that remain in public ownership because

privatization is not considered an option. From public-sector management reform programmes around the world, it can be seen that there is a standard agenda of topics, including:

(a) Civil service reform, corporatization, privatization, establishing clearer objectives for public institutions, restructuring such institutions to achieve greater focus and incentives for efficiency, budgeting and resource allocation processes that allocate public resources to high priorities, and instalment of improved financial management systems to report the stewardship of resources and the costs of service delivery;

(b) Programme evaluation and other techniques to assess the effectiveness of the activities of public-sector managers in terms of achieving the outcomes desired by a government;

(c) Information flows and incentives that promote accountability, efficiency and innovation over the long term.

III. PUBLIC FINANCIAL MANAGEMENT AND GOVERNANCE

34. The role for public financial management arises at a number of points when considering improvements to governance. Financial management involves the application of doctrines, principles and techniques, but it is wrong to conceive of a financial management reform programme as a technical solution in its own right. Any initiative in which improved techniques are appended to a country's Government without careful consideration of the wider issues of the roles, functions and structures of government and the key priorities that the Government seeks to address is unlikely to promote those objectives.

35. The public financial management system must be integrated into the total governance framework if it is to contribute as part of an organic whole to enhancing a country's development prospects. There are examples around the world of failures to achieve this integration, which show that it can result in wasted expenditures at best and dysfunctional management systems at worst.

36. Any particular financial management regime cannot be judged entirely on the basis of whether its various components conform to best practice. Rather, a successful financial management system is a core component of a total system of management and needs to work in harmony with the other elements (human resources, strategic and operational planning, information systems etc.) that are employed to achieve the objectives of government.

37. For example, the debate about whether accrual accounting should be used or not by Government occasionally misses the point. Accrual accounting is one accounting method that may provide vital managerial data in some circumstances; in others it is an expensive irrelevancy. Accordingly, any decision to adopt accrual accounting methods needs to be based on the particular data needs of public managers and not on purely technical considerations.

38. Lack of integration between the financial management system and the total management system can make administrative reforms fail or even represent a step backwards. For example, systems of central financial control that prohibit flexibility and innovation in public service provision are common. Similarly, drawing on the modern management philosophy of staff empowerment and granting managers freedom over the use of resources can be a risk in reform programmes in which such freedom is not balanced against those managers' explicit financial accountability.

39. In comparison with the traditional bureaucratic model of legislated responsibility, performance-based management systems focus on the specification and achievement of explicit goals in an environment of increased accountability. Such reforms reflect the views of the State that sees its public administration as an instrument for the delivery of economic, social and other goals. Within this rationalist view of the State, the task of the reformer is to find ways to improve the performance of the Government in terms of meeting these goals efficiently and effectively.

40. Put simply, the principles of effective management involve a clear expression of and agreement about objectives; managers who are accountable for results, the freedom to manage resources subject to incentives for efficiency and effectiveness, and clear information about performance.

41. While these simple principles of rational management underlie many recent public-sector management reform efforts and have long been established in successful private-sector organizations, it should be remembered that a high standard of organizational performance is ultimately established by people and not management systems. Management systems can increase the probability that people perform successfully but cannot guarantee it; by the same token, poor management systems can inhibit good performances by people who would otherwise be capable of achieving them. The human side of improving performance is fundamental to a holistic approach to improving public management.

42. It is useful to think of successful management as involving attention to

both the "hard" and the "soft" sides of management. The "hard" side of management involves setting goals, structures, systems, personnel policies, information technologies, financial management, controls and procedures etc.; such systems are sometimes known by management experts as "hygiene" factors, which establish goals, allocate resources, measure performance, control production and reward staff. The "soft" side of management involves motivational factors, such as organizational values, leadership, empowerment of staff, team-building, personal development, and strategic thinking in assessing and shaping the environment. It is generally thought by management experts that these softer elements of management make the key difference between a satisfactory and a high-performance organization.

43. The traditional bureaucratic organization, still found in many Governments, combines a management philosophy with a system for public service delivery that focuses on enforcing compliance with central requirements to achieve minimum performance standards that are universally applied. It is similar to the philosophy of management known as Taylorism, which typified private-sector management up until the 1960s.

44. The traditional bureaucratic model has increasingly come under attack in the government sector, as it did in the private sector and for many of the same reasons. Such organizations do not promote innovation, customer service and effectiveness in service delivery. Mass-produced services of indifferent quality, with little concern for the customer, have increasingly become unacceptable in the public sector, as they are in the private sector. To address the problem requires a complete reorientation of management systems and organizational culture, which most Governments are only just beginning to come to terms with even though such ideas have existed for a long time.

45. The theme of this reorientation will be one of empowering local managers to use resources in a way that will meet their customers and clients needs. The principle is not one of abandoning control but of finding more effective and efficient ways to deliver public services. It should be noted that control over the higher purpose of delivering a government's strategic objectives can be significantly increased if managers provide a higher quality service and are responsive to policy direction.

46. To ensure that outcome, the administrative centre of government needs to be redesigned so as to strengthen its policy development capacities and to develop more sophisticated oversight capabilities in order to monitor the performance of delivery agencies.

47. In 1983, the Office of the Auditor General of the Government of Canada published a report entitled "Constraints to productive management in the public service". The key finding of the report is that in the traditional bureaucratic hierarchies, the aim of management is to define the best way to do a job, to set standards for compliance, and to monitor and control people to ensure that they comply. That approach results in efficient production when work is routine, repetitive and predictable. However, when there is much uncertainty, complexity, rapid change and high interdependence, the control-based approach loses much of its effectiveness. Organizations performing well have moved beyond bureaucracy and are able to achieve value for money even in complex and rapidly changing environments. This change in mind-set and values from a control-based approach to a commitment-based approach is the most striking overall finding in the study.

48. Notwithstanding the many theoretical and practical developments since 1983 in the area of managing a post-bureaucratic government, the essential message of the present report is contained in the above-mentioned key finding.

49. The broad perspective on management systems and current trends in management reform yields a particular perspective on financial management and its potential contribution to a country's development. Located on the "hard" side of management, financial management is about implementing concepts, systems and processes that establish essential hygiene factors in an organization or in a government as a whole, enabling satisfactory accountability for resources to be achieved. The financial management system needs to be implemented alongside and in harmony with the other basic modules of a management system.

50. These systematic approaches to management will not, however, ensure innovation and high performance by a government in delivering quality public services and meeting national objectives. They are necessary but not sufficient conditions for that. Good financial management systems can bring major improvements in government-wide budgeting, reporting and fiscal policy, but the softer aspects of management can be seen to have the greater effect at the individual organization level.

51. In the case of the reforms of the Government of New Zealand, an entirely new performance-based management framework was imposed over the whole central Government at one time. While performance as a whole rose, the performance variations observable after a few years was largely explained by differences in top management skills.

52. Good financial management is no more nor less than one of the important

conditions necessary for improved performance.

A. Accountability

53. Accountability is a broad principle, with profound implications at all levels of public management. It has to do with holding institutions and people responsible for their actions. Traditionally, Governments have emphasized organizational forms in which responsibilities are arranged hierarchically, with the ultimate responsibility for detailed decisions resting at the top, with the executive or legislature itself.

54. In parallel with trends towards decentralization and customer orientation in the private sector, there have been trends towards decentralization within Governments along with greater emphasis on public participation and concern for clients and consumers of public services. These changes reflect a wider acceptability of more democratic and participatory modes of power sharing. This process is endorsed in the knowledge that any well-managed government will need to retain financial accountability over the use of public resources.

B. Transparency

55. Closely related to the developments in government management methods are schemes designed to enhance transparency, or the availability of good-quality information to interested parties and the public at large. Good quality information available from public and private institutions strengthens the motivations of managers and politicians to ensure that results are achieved and resources well managed.

56. Transparency applies not just to information but to government processes themselves, such as procurement procedures and fiscal and economic decision-making. It is important to note that increased transparency is fundamental to any efforts to improve government management and to recognize the role that effective public financial management can play in enhancing transparency. The profession of accountancy can be seen as the application of a set of codes and principles that are designed to provide key information to interested parties about the affairs of government and business.

IV. FISCAL AND STABILIZATION OBJECTIVES

57. A developing country's plans for social and economic improvement can, as in developed countries, rise or fall with the strengths and weaknesses of fiscal and stabilization policies. This usually requires consideration of fiscal policy from a top-down perspective. However, in economies with serious fiscal imbalances, a reconsideration of policy, financial and management frameworks is required from the bottom-up if macroeconomic objectives are to be met. A typical description of this second approach is that it is useful and conventional to distinguish two elements of the adjustment package to rescue an economy from a crisis and move it to relative price stability and the resumption of growth. One is stabilization, which is necessary to correct the underlying macroeconomic imbalance; the other is structural reform centring on the supply side, which is necessary to change incentives and restructure the distorted microeconomy usually encompassing a series of market-oriented reforms, such as trade liberalization, public-sector reform and financial sector reform, and also fundamentally redefining the role of government.

58. Further, this approach assumes that fiscal and monetary restraint are necessary for the resumption of sustainable growth and poverty reduction.

59. The fundamental strategic principles of fiscal policy are universal, even though the form and content of the details at any time and place are determined by immediate circumstances. Fiscal policy is the financial manifestation of the whole of a government's programme for development. It is a reflection of the aspirations, politics and decision-making processes of a society. It is the outcome of the struggle over interests, ideas and resources in any country.

60. It is of interest to compare fiscal policy institutions with those of monetary policy, the other macroeconomic lever. Successful monetary policies can be based to some extent on abstract ideas and a highly structured institution, such as a central bank, which can have considerable autonomy from the executive and legislative decision-making processes. There can be no equivalent institution implementing fiscal policy. Success in the areas of fiscal and stabilization policy involves channelling the forces behind fiscal decision-making into processes that have integrity, stability and access to high quality information. These processes are overseen by institutional frameworks that can impose a top-down pressure for coherence in the relevant aggregate indicators over long periods of time. At the strategic level, the same can be said of successful monetary policy. What is very different about fiscal policy, however, is that this pressure from the top for strategic coherence must be integrated with intricate, detailed decision-making about all the components of

government's presence in the economy that result in fiscal flows.

61. There needs to be harmony between the pressure exerted by a broad strategic framework and the incentives for institutions that spend or earn money to maximize their efficiency and effectiveness. This harmony is very hard to achieve and easily lost. It is common for countries to try to control their fiscal aggregates by broad-brush expenditure cuts, across the board tax increases etc. Observations over many years of fiscal stress in a number of countries indicate that this approach rarely works, even temporarily. It usually causes disruption to the public institutions that are subject to centrally directed funding cuts, as well as to private-sector consumption of public services or the taxes that it pays.

62. The elimination of serious fiscal imbalance requires a long-term programme of structural reform of both the expenditure and revenue practices of government and needs to be integrated with a programme of public-sector reform.

63. Major fiscal imbalances can be removed over time if a government initiates several simultaneous actions. Firstly, the Government needs to define its role in the economy, so that it is only present where it can better deal with issues than the private sector. Secondly, the Government needs to establish systems of governance, resource allocation, management and evaluation that ensure that all its institutions are providing more and better services each year, within constrained budgets. Thirdly, the tax system needs to be based on the fundamental principles of a broad tax base, with stable tax rates and tight tax administration. With such a programme in place, fiscal balance can be restored.

64. In addition, there is a time dimension to take account of the fact that there are major items of public expenditure that involve very long-term commitments and need to be planned over a long period. In countries that are members of the Organisation for Economic Cooperation and Development, the effect of ageing populations on the demands for medical services and income support are a prime example of the need to take a very long-term view of fiscal policy.

65. Focusing on the expenditure side, these issues require an approach to planning, budgeting, management and reporting that calls for a sophisticated application of the principles of modern financial management.

A. The New Zealand case-study

66. The application of the above-mentioned fiscal and stabilization concepts

can be usefully illustrated by consideration of the case-study of New Zealand, where successive Governments over a 10-year period set out to solve problems of fiscal policy at the macroeconomic level and also problems of poorly designed government intervention and inefficiency in the performance of government institutions. The details of that experience have been described in full elsewhere and only a few key points relevant to the present paper are elaborated upon here.

67. In the mid-1980s, the Government of New Zealand faced a fiscal deficit that was 9 per cent of gross domestic product (GDP), about two thirds of which was structural. That is, the deficit would have been roughly 6 per cent of GDP if the level of GDP had been consistent with the maximum non-inflationary rates of capacity utilization and unemployment. This deficit was measured on a cash basis within a financial management system that took no account of movements in assets and liabilities, including contingent liabilities. Beneath the official figures lay contingent liabilities of a further 10 per cent of GDP that came to charge when a number of energy-based industrial developments that had been supported by the Government needed financial restructuring after the drop in the oil price in the mid-1980s. Government-owned businesses produced 12 per cent of GDP and 17 per cent of national investment. All of these were not paying an adequate rate of return to the owner, or indeed any rate of return at all. The Government's total investments in these businesses was equivalent to around 30 per cent of GDP and on balance they made no return to the shareholders. This investment figure is based on crude estimates of historical book values from the 1980s. The cash-based accounting system in place at that time did not record asset values in accordance with accepted accounting principles, if it recorded asset values at all.

68. The tax system in New Zealand at that time had a narrow base that depended on income taxes, selected sales taxes and trade taxes, but there was no broad-based consumption tax. The tax system was used to deliver a large range of concessions to favoured groups in the economy. In the top income bracket, marginal income was taxed at 66 per cent. Social policies in New Zealand at that time were based on universality, with no fees for a wide range of social services. Most of these involved entitlements for which there was no effective budget constraint. The non-commercial public sector had highly centralized management systems and created incentives for low productivity and indifferent levels of service.

69. The approach taken to dealing with that fiscal problem involved a comprehensive redefinition of the role of government in the economy and the society, although attaining fiscal goals was not the only or even the primary

reason for the reforms initiated. The main elements of the reform programme were as follows:

(a) The Government put all its commercial activities into companies incorporated under New Zealand commercial law and put experienced business people in charge of these companies. The objective was to run a successful business, rather than any non-commercial objectives. All the subsidies and privileges to these businesses were removed and they were required to pay taxes and dividends equivalent to those that similar businesses would pay in the private sector;

(b) Many of these businesses were subsequently privatized, with total asset sales approximately equal to between 15 and 20 per cent of GNP. These receipts were applied to amortize approximately 30 per cent of the Government's debt stock;

(c) The remaining government departments and agencies were subjected to structural reforms that conformed to the principles mentioned above in terms of solving public choice and agency cost problems. Separations were introduced between policy and operational functions and between the funding, purchasing and provision of many services. Competition for funds between government service providers was established in many areas;

(d) Government institutions were given a management framework that applied the following basic principles of management: clear objectives, resources allocated to achieve results, freedom for managers, accountability for performance and full information to stakeholders;

(e) Under the State Sector Act, the chief executives of all government agencies were placed on five-year contracts with explicit performance agreements, that included an obligation to deliver outputs and achieve critical results specified by government policy. Their remuneration was raised to be closer to the equivalent market salaries for similar jobs and bonuses for performance were introduced;

(f) Chief executives became the employers of all staff working in their departments, so they could negotiate freely to establish a human resource management system that increased the effectiveness of the department's operations;

(g) Under the Public Finance Act, the budget processes were changed to allocate resources to each of the outputs that they were required to produce, so the relationship between the Government and the chief executives became that of purchaser and provider of public services;

(h) The Appropriation Acts were redesigned so that parliamentary appropriations related to outputs costed according to generally accepted accounting principles, resulting in costs calculated on an accrual basis rather than the more common cash basis. Each department had its own accrual accounting system, its own bank account and its own internal audit system. Cash was injected into the departmental bank accounts in accordance with approved annual business plans and any surplus funds in departmental bank accounts were aggregated and invested by the Treasury;

(i) All the accountability documents for reporting to the Executive, the Parliament and the public were changed to reflect this fundamental reorientation towards outputs and the use of generally accepted principles, except as modified to handle unique issues in government;

(j) Social services were redesigned to target government assistance to those with the greatest need, using both the taxation and social service delivery systems. Fees were introduced for certain public services that were mostly income-related. Separation of responsibilities between the purchaser, provider and funder permitted the Government to impose budget constraints, with varying degrees of hardness or softness, over areas of spending that were previously open-ended entitlements.

70. These steps made a fundamental change in the design and implementation of both fiscal policy and the delivery of government services.

71. These financial management concepts and systems reflect standard practice from the private sector, modified to deal with matters unique to the public sector. What was unusual was the comprehensive way in which these concepts were applied across all areas of government activity.

72. The results of these changes in aggregate were that government expenditure fell from a peak of 43 per cent of GNP about the time the last of these systems were installed in 1990, to 35 per cent in 1995. Staff numbers in the core central government administration fell by more than half; many of these people moved out into government corporations or into the private sector.

73. Concerning the administrative aspects of government, budgets were squeezed quite hard over a period of several years to produce a mixture of efficiency gains and reprioritization of services. In most areas, efficiency gains were

taken out in the form of higher-quality public services. It also needs to be recognized that part of this decline in the ratio of government expenditure to GNP may be cyclical, since a strong economic recovery occurred after 1991.

B. Stabilization and long-term fiscal objectives

74. The New Zealand experience is far from unique in its finding that the standard macroeconomic arguments for counter-cyclical fiscal policy in fact led to a ratchet effect with the degree of fiscal stimulation in recession usually being larger than the ensuing degree of fiscal tightening in recovery. There is also some evidence that the attempts at stabilization were in fact adding to instability. It is thought that those problems came about because of the time-lags that arose between recognizing and then reacting to events that justified discretionary intervention, as well as inadequate financial data and asymmetric incentives for political decision makers at different stages in the economic cycle.

75. Continuing fiscal stress, together with capital restructuring requirements for the many bankrupt government-owned and subsidized enterprises, contributed to a build-up of debt. Debt accumulation commenced in the years before reforms began and continued until fiscal surpluses were realized in 1993-1994. This resulted in declining credit ratings, with consequent effects on interest rates.

76. Finding practical ways of balancing short-term fiscal policy objectives with medium and long-term goals has produced interesting debates in many countries. The United States experience, with attempts to legislate restraints on fiscal policy, has produced valuable evidence of the difficulties of trying to find ways to keep the short-term political processes of fiscal policy within the envelope of a long-term fiscal strategy aimed at stable and generally low levels of debt and taxes. This mirrors the reality that the level of taxes is driven by the level of spending, which reflects the role the Government chooses to take in the economy. The United States experience suggests that legislative restraints on the quantitative size of the fiscal deficit can be dysfunctional, because they create strong incentives for moving policies off-budget and using creative accounting techniques to evade the constraint.

77. An alternative approach, taken in New Zealand's Fiscal Responsibility Act, is to emphasize full disclosure, or transparency of the Government's short and medium-term fiscal policy objectives and to identify the long-term fiscal consequences of the current fiscal policy. A list of criteria are written into law, which is used as a checklist against which to judge the fiscal stance.

Government is expected to explain its policies with reference to these criteria. New Zealand's Fiscal Responsibility Act incorporates the following fiscal management principles:

(a) Reducing total government debt to prudent levels by achieving operating surpluses every year until a prudent level of debt has been obtained;

(b) Maintaining total government debt at a prudent level by ensuring that on average the operating expenses of the Government do not exceed its operating revenue;

(c) Achieving and maintaining levels of government net worth that provide a buffer against adverse future events;

(d) Prudent management of the fiscal risks facing the Government;

(e) Pursuit of policies consistent with a reasonable degree of predictability about the level of stability of tax rates for future years.

78. Against this general background of principles, the Government is free to pursue short-term fiscal stabilization measures that it believes will smooth the business cycle.

79. The New Zealand case study overall can be seen as the application of the core principles of financial management right across the public sector of New Zealand. It is important to note, however, that the most profound impacts of this kind came about by changing the institutional forms of government organizations, particularly through corporatization, rather than any attempt to apply improved techniques of financial management across an unreformed public sector.

80. There had been some attempts at pure financial management reform at an earlier stage in New Zealand, which basically failed. Those reforms were in accordance with best international practice at that time but failed to meet the broader objectives of fiscal and financial policy. Public servants attempting to adopt effective fiscal management practices were limited by direction from the then Minister of Finance and obstructed by managers of State enterprises - such as telecommunications and railway enterprises - that benefited from extensive cross subsidies, an issue that proper accounting practices would have exposed.

81. It could be said that the improvements in financial management were a

consequence of wider reforms to the role of government and management systems in search of greater effectiveness, rather than any specific financial management initiative as such.

V. BUDGET AND PUBLIC EXPENDITURE PROCESSES

82. The processes by which the government budget is formulated and executed is critical to the achievement of fiscal and economic goals: they affect the decision rights of the many parties involved, the information they have to work from and the incentives they respond to.

83. Effective financial management demands a budget and public expenditure management process that:

(a) Are oriented towards medium and longer-term strategy and minimize friction between macroeconomic requirements and the management requirements of agencies, and have the backing of the law;

(b) Are stable and predictable, year by year;

(c) Establish very clear rules about entitlements and accountability for spending;

(d) Produce clear information about the purposes of public expenditure, at least in terms of inputs and preferably in terms of outputs as well;

(e) Provide strong incentives to accountable officials to stay within their budgets and to spend money as intended.

84. While this list of features is somewhat obvious, most government budgetary and expenditure systems do not exhibit all of these features. The budget and expenditure process is a set of rules that defines the terms for political debate about the role of government and the use of public resources. Disagreements between people and institutions within the executive and the legislature will often, either by accident or design, disrupt the budgetary process itself. Observations in many other countries indicate that disruption to budgetary processes ultimately leads to irrational allocations of public expenditure. The result can be a budget that no party feels responsible for. It is simply the outcome of an unreliable process.

85. One common manifestation of an unsatisfactory budget process is the budget

with a fiscal deficit that all parties to the debate say they were opposed to. Also typical of unsatisfactory budget processes are budgets that respond excessively to short-term pressures while building up serious problems for the medium and longer term. As noted in the previous section, it is not productive to put quantitative fiscal objectives over the top of the fiscal decision-making process. However, it is important to establish a firm process that is well understood, is based on complete fiscal information and provides options for decision makers, not just in the short term but over a period of years in order to ensure that a desirable framework of fiscal policy over the longer term can be imposed on short-term decision-making. In practice, this is very hard to achieve.

86. Experience in the United Kingdom of Great Britain and Northern Ireland, Australia and New Zealand over the past 15 years provides evidence that gaining control over the level and distribution of public expenditure requires very determined action by the top leadership and the executive, backed by strong, and even somewhat rigid, processes for preparing advice and making decisions.

87. The United Kingdom adopted a very tight cabinet process in the early 1980s, which was used to impose priorities and limits on spending. This process restricted the extent to which cabinet ministers were able to place their individual priorities ahead of the strategy for attaining overall fiscal objectives. Once the key strategic decisions about the fiscal situation were made, the Chancellor and the Chief Secretary took control of the funds allocation process for ministerial portfolios. A so-called Star Chamber, headed by another senior minister, was used to consider particularly difficult issues. Ministers were not allowed to bypass these procedures by taking expenditure proposals directly to the Prime Minister or Cabinet.

88. In the 1980s in Australia, the Prime Minister, the Treasurer and other senior ministers formed a subcommittee of the Cabinet that set strategic directions and priorities and made recommendations to the Cabinet on the direction of expenditure. The Department of Finance was then given considerable authority to meet budget objectives by setting the funding levels for departments.

89. In New Zealand in 1990, a Cabinet Expenditure Committee was established to control the flow of advice on expenditure matters going to the Cabinet. This senior Committee was advised by an Officials Expenditure Committee, chaired by a senior Treasury officer. The Cabinet Expenditure Committee had other senior ministers on it besides the Minister of Finance, including a high-ranking minister charged with expenditure control. This Committee was greatly assisted

in its work by the output-based budgeting system, which enabled the Committee to review the cost of outputs delivered by departments and to decide whether government should continue to provide these services. This process was more rational than second guessing public service managers' requests for inputs, with little information about the ultimate purposes of the expenditure.

90. In each of these three examples, the systems of expenditure control were very successful in changing the levels and priorities of spending, which compares favourably with the less rigorous approaches that were previously applied in all three countries.

91. An important technical issue concerning the fiscal information presented to government, which arises in both Australia and New Zealand, is the use of baseline expenditure forecasts to open departmental budget discussions in each round of the budget formulation process. These baseline forecasts are the next-year implications of budget decisions made in the previous year and therefore do not incorporate a current "wish list" of activities not previously considered. By contrast, it is a common feature of budgetary processes in many countries that the debate about expenditure opens on the basis of departmental requests for next-year funding made in the current year.

92. Besides these difficulties in the budget formulation process, there can be serious problems in budget execution. For example, in some countries of the former USSR the legislature authorizes more spending than there are funds available. Strong central controls are needed to manage this problem and so ensure that the available resources are applied to priorities determined by the Finance Ministry.

93. Many countries have concerns about whether funds will be spent by agencies in accordance with the intentions of the legislature and in accordance with central line-item controls. The typical response is a detailed central financial control system that can now be efficiently implemented through the use of computers. Brazil has a highly computerized system of this kind, whose concepts have been recommended for use in other countries, such as the former USSR.

94. Countries in the French tradition also prefer very strong central control by a central finance department over detailed spending by line departments and other agencies.

95. To the reformers who favour decentralized management systems, centralized systems have the inherent disadvantage of tying local managers up in red tape

that distorts their incentives away from effectiveness and towards compliance.

96. The integration of the development planning processes with budget processes is a significant issue for many countries. It is very common for countries to have development plans and fiscal objectives that do not actually drive the outcomes of budgetary processes. Many developing countries have budgetary and development planning cycles that are not well coordinated or are even in conflict with each other. As a matter of principle regarding public financial management, there is no reason why the financial aspects of development planning should be separate from the budget process. Indeed, there are many theoretical reasons for combining the two processes, including the need to meet the requirements of donors and external financiers, who see such a combined process as a way of influencing priorities, earmarking and keeping track of funds.

VI. FINANCIAL INFORMATION SYSTEMS

97. It follows, from the need to fully integrate public financial management with wider public management, that any information systems developed to collect and disseminate public financial information should also be integrated within the wider public management information systems.

98. In practical terms, this means that the financial information requirements for public management should be designed to reflect the fundamental accountability structures of the public administration. In a highly centralized system in which detailed financial control is maintained at the centre of the Government, an information system that tracks detailed expenditure items over the whole of the Government and feeds information into the centre as in Brazil, could be appropriate.

99. Where the fundamental accountability structure of government reflects a high degree of delegation for decision-making about resources into the management of the departments, then the information flows passing from the business units to the centre is highly aggregated. Financial data should also be collected in a way that reflects the costs of delivering public services for performance monitoring purposes; specific accountability details of control over expenditures should remain at the departmental level. This type of output-based financial reporting system also requires an activity-based cost accounting system to properly allocate the full costs of running a department to the outputs it is producing.

100. In a decentralized accountability system, the key principle in the design

of information systems is to pass information to those people with the authority and incentives to take action on it. The information flows are more likely to fit the following pattern:

(a) Information about the monitoring of critical success factors is passed to the people who have the authority to respond quickly in the workplace. A lot of this information is very decentralized, although information about the achievement of strategic goals goes to the centre;

(b) Management information needed to prepare standard accounting reports, annual accounts etc. flows routinely to the centre;

(c) Central management has an internal audit or management assurance function that routinely checks the key operations of the organization and responds to failures.

101. Drawing on experience from the implementation of the integrated financial management system in the Government of New Zealand, the key lesson to emerge was that distributed processing on personal computers was cheap and perfectly satisfactory for most public financial management applications: there was no need for large-scale computer development.

VII. DEVELOPMENTS IN THE LONGER TERM

102. The terms of reference for the Twelfth Meeting of Experts on the United Nations Programme in Public Administration and Finance include an analysis of public financial management issues in the twenty-first century. While any analysis of the future is necessarily speculative, current developments imply a future direction that is quite clear.

103. Rising expectations for higher-quality public services and greater efficiency in the management of Governments will lead to continuing international pressure to reform traditional bureaucratic structures. While the conventional view is that the pressures of an international economy will force Governments to shrink their activities, it seems more likely that they will continue to assert their sovereignty by choosing to intervene in economic development processes on ideological and practical grounds. But however big or small a government may choose to be, given the adverse effects of international competitiveness on an economy that is poorly managed in terms of policy and administrative efficiency it will be under relentless pressure to become more efficient.

104. The movement towards greater managerial efficiency will continue and will be heavily influenced by trends in management in the private sector, which in turn seem likely to continue to emphasize customer focus, decentralization, the empowerment of staff and an organizational culture biased towards innovation.

105. Reform of government institutions both on and off the budget will therefore tend to emphasize greater accountability for producing results.

106. The consequences for financial management systems will be that they will move towards adopting accrual accounting methods, charging for capital and other inputs that improve the measurement of resource use by government.

107. It is already clear from the experience of many countries around the world that reform of financial systems along such lines is easier to achieve than the delegation of management authority to skilled managers who are accountable for results. The traditional control agencies at the centre of Governments generally support improved flows of management information but resist any dilution of their traditional powers of detailed management control. Central agencies rarely recognize that they can strengthen their abilities to set strategic priorities and shift resources flexibly through decentralized management techniques. Adopting decentralized management techniques is demonstrably difficult to do within traditional incremental and centralized budgetary mechanisms. While the rhetoric of decentralized, empowered management has spread around the world and is to be found in the writings and speeches of senior central government officials and politicians, the reality in most cases is very different.

108. This is not a surprising outcome. The experience of countries that have undertaken management reforms has been that a heavy pressure was exerted on departments to learn new skills, change the way they think and down-size. Yet even in counties in which reforms have proceeded, there are still pressures to reintroduce central controls, although of a different character from those that were formally abolished.

109. As a result of these forces opposed to management reform, it can be expected that the few highly decentralized management systems that have emerged, such as the New Zealand model of personal delegations, are not likely to be widely adopted unless they continue to be successful in the countries that pioneered them.

110. An evident global trend is the contracting out of various government functions, again in imitation of the privatization movement. Sometimes this is

done for the promotion of new industries in the private sector or for gaining access to private-capital markets in the case of Governments whose policies are causing them difficulty in borrowing on their own account. The scope for these public-sector/private-sector partnership arrangements is almost limitless: the core of services that Governments must provide for constitutional reasons or because it would be impractical to write an out-sourcing contract is much smaller than the totality of government activities in most countries today.

111. There is a rapidly developing industry on an international scale, namely the supply of a very wide range of products and services to Governments that they previously produced themselves. For example, European-based companies are prominent around the world in the management of water and sewage utilities and the same is true for a wide range of other utilities. There is no reason, in principle, why postal services could not be contracted out or privatized. Essentially all the support services in the military, health, education and other social service sectors could be out-sourced. Information processing services are commonly contracted out. A state government in Australia has let a contract for all its information-processing requirements. Government agencies in many countries have become involved in a growing international industry of contractual public services supply.

112. These trends will expand rapidly as Governments find themselves faced for the first time with the possibility of buying services much cheaper and better than they can make them themselves. Governments will be open to the possibility that any country in the world can provide their citizens with high-quality public services within the limits of its budget if they are prepared to make reforms to overcome the capture of public-service provision by entrenched political and civil service interests.

113. Taken to its logical conclusion, this approach suggests a vision of government in the future in which Governments may secure high-quality services available in local and international markets, as long as they are prepared to abandon their own monopoly on provision. Governments would shrink to a core of strategic and constitutional functions, supported only by the administrative functions that these require.

114. Such Governments would have to be skilful in the writing and monitoring of contracts to private providers, some of which may be local citizens' organizations. Contracting problems could be reduced or eliminated if a policy of issuing vouchers for public-service procurement, which would enable the public to purchase privately provided services directly, were introduced.

115. One of the lessons from experience in public-private partnership arrangements is that the contracts can be very difficult to write and administer. Out-sourcing services can be worse than maintaining public provision if it passes the right to excess monopoly returns to private providers as a result of poor contracting or inadequate regulation. If a private provider can find a way of leaving financial risk with the Government, it will usually do so. The financial manager of the future is likely to be monitoring financial performance information coming from these out-sourced contracts and analysing them for hidden transfers of wealth.

116. It will be of concern to Governments that any private contracts let for the supply of essential services do not expose the community to greater than normal levels of service disruption: ensuring long-term continuity of supply is the key management objective. The circumstances of each situation will dictate the specific contractual response that can be taken by public managers, but some guidelines are noted below.

117. Contracts with implicit incentives to run down assets for short-term economic gains, thus threatening continuous supply of services, need to be avoided. Monopoly rights should not be granted to service providers, since this would force other suppliers out of the marketplace and remove alternative sources of supply should the contractor fail to deliver services. In some circumstances, however, it may be difficult to avoid granting monopoly rights, depending on the nature of the service.

118. Private-sector providers of modest commercial substance may be willing to maximize short-term profits by providing substandard services and should be avoided when contracting for essential service supply. Internationally and locally reputable firms will have stronger incentives to ensure that Governments are satisfied with their services and will bolster their reputation with a consistent supply of services.

119. The commercial legal framework and economic management policies of some developing countries do not adequately protect the value of a private-sector service provider's investment. Consequently, such providers can be discouraged from entering into public service supply contracts without guarantees from Governments that they will absorb all economic risks associated with the contract.

120. On present trends it is also likely that the well-run Government of the future will have financial and other management information systems that generate data to monitor the achievement of outputs and the resulting outcomes

of its service delivery institutions. For example, under the Government Performance and Results Act in the United States of America, comprehensive reporting on the ultimate outcomes of government activities should be in place early next century.

121. The successful Government of the future will have information systems that enable effective formulation and assessment of major strategic goals, which in turn will support a cycle of perpetual evaluation and modification of its performance and thus achieve its strategic and operational goals. Such a government might be termed "The learning Government".

VIII. CONCLUSION

122. The following critique of financial management in developing countries was recently made:

(a) Financial management was dominated by central controls that were excessively process-oriented. Effective communication between the central and the spending agencies about resource realities was lacking. Centralization, while contributing to an avoidable abuse of power and trivializing controls, imposed an additional strain on the process and on policy makers. More important, it contributed to a loss of financial consciousness in the spending agencies. As the types and instruments of control increased, efforts to control waste and abuse of authority became diffuse and lacked accountability. Procedures and rules were frequently perverse and overwhelmed substance and control became more important than achievement, resulting in managers losing their sense of relevance and control.

123. For too many countries, the situation has not improved on that described above. The techniques of modern financial management are not especially complex but their contribution to improving government management and thus advancing development is dependent on taking a system-wide approach to fiscal policy implementation and public-sector management.

124. A government determined to take such an approach can incorporate a financial management system that makes major contributions to the development of fiscal strategy, the quality of fiscal decisions, the reliability of the budget and expenditure processes, and the quantity and utility of information at the disposal of the legislature and the public. It can also enhance the information available to and incentives for public-sector managers in their quest for efficiency and effectiveness in delivering public services.

125. While there are many circumstances in developing countries that seem to justify central controls over-line item expenditures, there is a fundamental conflict between such controls and the pursuit of improved and cheaper service by empowering managers to manage while holding them directly accountable for results achieved. Effectively performing public institutions are essential for development and require motivated, competent managers with high levels of integrity who have been given the freedom that they need to manage and innovate; the question for many countries is how to create such institutions. There is no simple answer to that question other than the observation that public-sector management reform, including advanced public financial management systems, is a necessary component of strategies for moving from crisis to development.
