2. Fiscal Responsibility and Accountability

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Rome, February 6-8, 2017
Outline

- Preview
- Defining responsibility and transparency
- Why responsibility/accountability now

Part II
- Role of information
  - Coverage
  - Timeliness, frequency, quality, and integrity
  - The art of consolidation
- Concluding remarks
Portugal

General Government Gross Debt

SOE & PPP reclassifications post Dec 2009

Financial sector bailouts

SOE & PPP debt outside the General Government sector

Deficit dynamics

3% deficit

GG Gross debt reported in Dec 2009

Arrears

60% debt

General Government debt excluding reclassified SOEs, PPPs or financial sector*

Anything that could go wrong did go wrong
Definition(s)
Fiscal responsibility is defined as:

an agreed set of policies, processes, or arrangements intended to improve fiscal outcomes, discipline, transparency, and accountability by requiring governments to commit to monitorable fiscal policy objectives and strategies.

- Often stated on legislation (FRL)
- Constrain discretion
- Reputational investment and costs
- Adequate PFM systems
Government, public interest, governance, accountability

- To get the conversation going, what is a government?
  - Is it all in providing public goods? But what are these? Is it all relative?

- How do we define public interest?
  - A contextual term that requires more specific definition that the ones typically found in national constitutional mandates or religious prescriptions.
  - In other words, the quest for an objective definition of public interest has proven somewhat illusory, as it requires, for instance, an explicit value judgment on income redistribution within a given society as well as on the role, function, and size of government.

- What is governance?
  - Normative (value based) vs. positive (fact-based) approach

- How can governments be accountable?
  - Information
  - Independent evaluation
  - Increasing public participation
Governance

• The general exercise of authority
• The arrangements whereby intended outcomes for stakeholders are defined and achieved.
• Government’s ability to make and enforce rules, and to deliver services (Fukuyama (2013)).

  – Problem in trying to make the concept operational.


  – Confusion between good governance—a means to an end—and what is government—which raises the issue of its political arrangements and pursue of social objectives.

  – Define and possibly contextualize the concept in as much operational terms as possible
Budgeting

• Governance and budgeting often used interchangeably in agenda aimed at reforming public management—functional definition.

• Budgeting—"attempts to allocate financial resources through political processes to serve different human purposes," Wildavski 1975.

• Public financial management —broader context (public sector); analysis of fiscal risks; transparency.

• Legitimate to compare across different contexts?
Types of FRLs

• *Fiscal responsibility principles* (transparency, accountability, and sustainability), but does not identify in detailed terms how these principles are to be met.

• *Procedural rules*, both for fiscal transparency and the fiscal process.

• *Rules for the stance of fiscal policy or places limitations on key fiscal policy aggregates.*

All of them rely on transparency and good quality information
Key PFM Requirements

- Well-structured cabinet decision-making over the medium term
- Fiscal policy analysis and ability to set fiscal targets
- Credible budget formulation and preparation
- Reasonably reliable macro and fiscal forecasting
- Effective and disciplined budget execution
- Accurate, timely and reliable fiscal monitoring and reporting
- Independent review of fiscal policy outcomes
- A credible medium-term fiscal framework (MTFF/MTBF) and a monitorable fiscal strategy
- Costing of new and existing policy measures over the medium term, i.e., definition of baseline
- Setting and executing fiscal policy in line with tightly defined numerical limits
Transparency: IMF 2012

• **Fiscal transparency**: the clarity, reliability, frequency, timeliness and relevance of public fiscal reporting and the openness to the public of the government’s fiscal policy-making process.

• **Public fiscal reporting**: the publication and dissemination of summary information about the past, present, and future state of the public finances to citizens in the form of:
  – fiscal forecasts and budgets;
  – government finance statistics; and
  – government financial statements or accounts

• **Fiscal risks**: factors that lead to differences between a government’s forecast and actual fiscal position
Why earlier attempts did not deliver?
Empirical evidence not overwhelming

• On average, more transparent countries have better fiscal outcomes, but does transparency cause the improvement in fiscal outcomes?
• Or are countries with better fiscal outcomes more inclined to publish information on public finances?
• Or do other, underlying differences among countries lead to differences in both fiscal outcomes and transparency?
• Some studies find evidence that fiscal transparency leads to better outcomes, but causality remains an issue:
  – Alt and Lassen (2006): transparency leads to lower debt, controlling for other influences
  – Arbatli and Escolano (2012): transparency improves credit ratings, directly and indirectly
• But it is possible to develop models in which transparency is actually harmful (see Justin Fox, 2006)
Did we get the right incentives?

- Transparency (a positive message) confused with anti-corruption/good governance campaign (less positive).
- A moral category instead of a means to an end—fiscal responsibility and accountability.
- Another rich/western countries’ imposition.
- Good years are not conducive to change.
- ROSCs run out of steam as very rarely became subject of surveillance/conditionality...
- ...although they did flag the right issues, perhaps in a somewhat cryptic way.
- Other (too many?) diagnostic tools emphasized more the form over the substance—bets practices bias.
Is it always a good idea?

• “Sunlight is the most powerful of all disinfectants” (Brandeis)
• “There may be trade-offs between the value of sunlight and the danger of over-exposure” (Heald)
• Dumping extremely detailed and large amount of data may create a veil that fogs rather than sheds light on fiscal events.
• Information has to be vetted—with some degree of autonomy and independence—to make it comprehensive, reliable, timely, and most of all reliable.
• Risk of compliance or form vs. substance: OBI, Revenue Watch, and Publish What You Pay may provide an easy way out for government to perform well on their indexes without making a dent on fiscal transparency and accountability.
The illusion of transparency

• Publishing only partial information
  – Net but not gross spending
  – No information on off-budget government entities
  – Revenues and spending, but not assets and liabilities

• Publishing information that is difficult to understand
  – Without summary tables or explanatory text
  – Not on Internet, not easy to buy or borrow

• Exploiting weaknesses in accounting rules
  – Selling assets and treating the proceeds as revenue
  – Borrowing by issuing off-market derivatives when derivatives don’t count as debt
Layers of transparency?

• One can look at two levels of transparency:
  – The most important one is for decision makers to realize their true (and fair) fiscal (financial) position.
  – The fact that such information should be publicly available goes without saying but belong to a different—equally important—level.

• Transparency is also a prerequisite (necessary but not sufficient) for:
  – Accountability, which requires clear objectives and responsibility
  – Participation, within cabinet, between executive and legislature, civil society, but causality not obvious
Why now?
Why Transparency now?

• 2008 financial crisis...but it happened before...
• Fiscal adjustment may become an illusion
• Governments tend to disappear because of:
  – *hidden borrowing: pension schemes*
  – *disinvestment: privatization, securitization*
  – *deferred spending: cash/accruals, leases, PPPs*
  – *foregone depreciation/investment*
• Financial markets also seem to care—which will provide further incentives for sound fiscal policies
# Lessons from the Recent Crisis

## Sources of Unexpected Increase in General Government Debt
(percent of GDP, 2007-2010)

<table>
<thead>
<tr>
<th>Source of Increase</th>
<th>FRA</th>
<th>DEU</th>
<th>NLD</th>
<th>ESP</th>
<th>PRT</th>
<th>GBR</th>
<th>USA</th>
<th>GRC</th>
<th>IRL</th>
<th>ISL</th>
<th>AVE *</th>
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</thead>
<tbody>
<tr>
<td>Underlying fiscal position</td>
<td>1.7</td>
<td>3.2</td>
<td>-2.4</td>
<td>1.8</td>
<td>11.3</td>
<td>3.7</td>
<td>8.1</td>
<td>16.3</td>
<td>1.3</td>
<td>10.9</td>
<td>6.0</td>
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<tr>
<td>Revisions to 2007 deficit &amp; debt</td>
<td>1.7</td>
<td>1.8</td>
<td>-0.9</td>
<td>-0.1</td>
<td>0.1</td>
<td>1.5</td>
<td>7.1</td>
<td>2.5</td>
<td>1.6</td>
<td>4.0</td>
<td>4.7</td>
</tr>
<tr>
<td>Changes to government boundary</td>
<td>-0.7</td>
<td>1.4</td>
<td>-0.2</td>
<td>0.6</td>
<td>9.4</td>
<td>1.9</td>
<td>0.9</td>
<td>11.2</td>
<td>-0.1</td>
<td>2.5</td>
<td>1.1</td>
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<tr>
<td>Cash-accrual adjustments</td>
<td>0.7</td>
<td>0.0</td>
<td>-1.3</td>
<td>1.3</td>
<td>1.7</td>
<td>0.3</td>
<td>0.0</td>
<td>2.6</td>
<td>-0.2</td>
<td>4.5</td>
<td>0.2</td>
</tr>
<tr>
<td>Exogenous shocks</td>
<td>8.4</td>
<td>12.8</td>
<td>14.2</td>
<td>15.4</td>
<td>8.1</td>
<td>17.0</td>
<td>6.3</td>
<td>40.0</td>
<td>60.2</td>
<td>39.5</td>
<td>9.8</td>
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<tr>
<td>Macroeconomic shocks</td>
<td>8.3</td>
<td>4.7</td>
<td>5.2</td>
<td>13.0</td>
<td>4.4</td>
<td>8.9</td>
<td>3.8</td>
<td>38.4</td>
<td>35.7</td>
<td>-3.3</td>
<td>6.0</td>
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<td>Financial sector interventions</td>
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<td>9.0</td>
<td>2.5</td>
<td>3.6</td>
<td>8.1</td>
<td>2.5</td>
<td>1.6</td>
<td>24.5</td>
<td>42.8</td>
<td>3.8</td>
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<td>Policy changes</td>
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<td>1.9</td>
<td>4.9</td>
<td>4.7</td>
<td>1.1</td>
<td>6.4</td>
<td>-8.0</td>
<td>-9.9</td>
<td>-4.3</td>
<td>4.7</td>
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<tr>
<td>Other factors</td>
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<td>-0.3</td>
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<td>1.9</td>
<td>3.7</td>
<td>6.2</td>
<td>8.3</td>
<td>-6.7</td>
<td>7.5</td>
<td>21.6</td>
<td>5.9</td>
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<tr>
<td>Total Unforecast Increase in Debt</td>
<td>14.4</td>
<td>19.5</td>
<td>20.2</td>
<td>24.0</td>
<td>27.8</td>
<td>28.0</td>
<td>29.1</td>
<td>41.7</td>
<td>59.1</td>
<td>67.7</td>
<td>26.4</td>
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</table>
Main lessons

• Countries did not know their true fiscal position.

• Fiscal adjustment turned out to be an illusion as liabilities went undetected and accumulated outside the traditional perimeter of central governments’ budgets.

• In other words, there was poor quality information on fiscal developments.

• But financial markets started to care—which could provide further incentives for sound fiscal policies.
Markets seem to care ……

Fiscal Transparency & Fiscal Performance

Fiscal Transparency & Fiscal Credibility

Average Debt/GDP Ratio, 1997-2007

IMF Index of Fiscal Transparency

Average CDS Spreads, 2008-11

IMF Index of Fiscal Transparency
Average Annual Impact of “Fiscal Gimmicks and One-off Measures” in Europe (1993–2003; Percent of GDP), and relationship to CDS Spreads in January 2011

Accurate macro-forecasts

Figure 2. Average Error in Forecasting Real GDP Growth for Two Years Ahead, 2000-2007 (in percentage points of GDP)
Arrears: execution and reporting failures

In both countries, arrears emerged from outside the budget perimeter.

Greece
Arrears ≈ 4.3% of GDP
91% from outside the CG budget

Portugal
Arrears ≈ 3% of GDP
95% from outside the CG budget
How to improve fiscal transparency?

**Problem**

- Revisions to Deficits
- Quasi-fiscal Activity by SoEs
- Unreported Flows
- Macroeconomic Shocks
- Exposure to Financial Sector

**Weakness in Current Standards**

- Infrequent fiscal reporting
- Exclusive focus on general government
- Losses on asset & liability holdings not recognized
- Bias in macroeconomic forecasting
- No recognition of contingent liabilities

**Recommendation**

- Monthly operational fiscal reports
- Publication of fiscal data for public sector
- Recognition of doubtful debts in summary aggregates
- Alternative macro-fiscal scenario analysis
- Recognition of quantifiable contingent liabilities
Concluding remarks
Were problems addressed?

- After initial success, 1998 transparency initiative died out....
- A string of “good” years did not help, but....
- ....insufficient emphasis was put in surveillance and conditionality work.
- New emphasis after the 2008 financial crisis, particularly in EU:
  - First changes in 2005 to allow adjustment in structural terms (France and Germany). Then Fiscal Compact, Six Pack, and then two Pack...
  - Recognize more emphasis on ex ante surveillance—preventive arm—and certainty on adjustment path—corrective arm.
  - Align stability plans with national budget calendars
  - More rules and benchmarks on debt reduction and total spending
  - Minimum standards on accounting, MTBFs, rules, etc.
  - A stricter and ex post sanctioning mechanism
  - Centralized scrutiny on national budgets and independent fiscal agencies or councils in all member states.
Why problems persist

• Lack of focus on proper set of incentives....
• ..... one can lead a horse to water, but can't make it drink.....
• As in most change processes, underestimated cost disruption and strength of incumbents....the tyranny of status quo....
• Public goods vs. private/localized problems
• Remedies not adapted quickly enough—in fact, key aspects remain to be addressed (e.g., basic accounting standards or EPSAS).....
• .....but rely heavily on best practices—MTBFs, independent agencies, rules and more rules with ex post sanctions rather than ex ante responsibility—and a regulatory approach, that is no cultural change yet
• As result, reforms are largely compliance-oriented exercises, driven by announcements rather than addressing member states’ real problems
• De jure vs. de facto gaps rapidly widened as virtually all national legislations (starting with constitutional laws) amended to transpose EU provisions
• Very little real improvements—let alone reforms—in national systems although many problems (e.g., expenditure arrears) persist....
Selected references

