2. Fiscal Responsibility and Accountability

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Outline

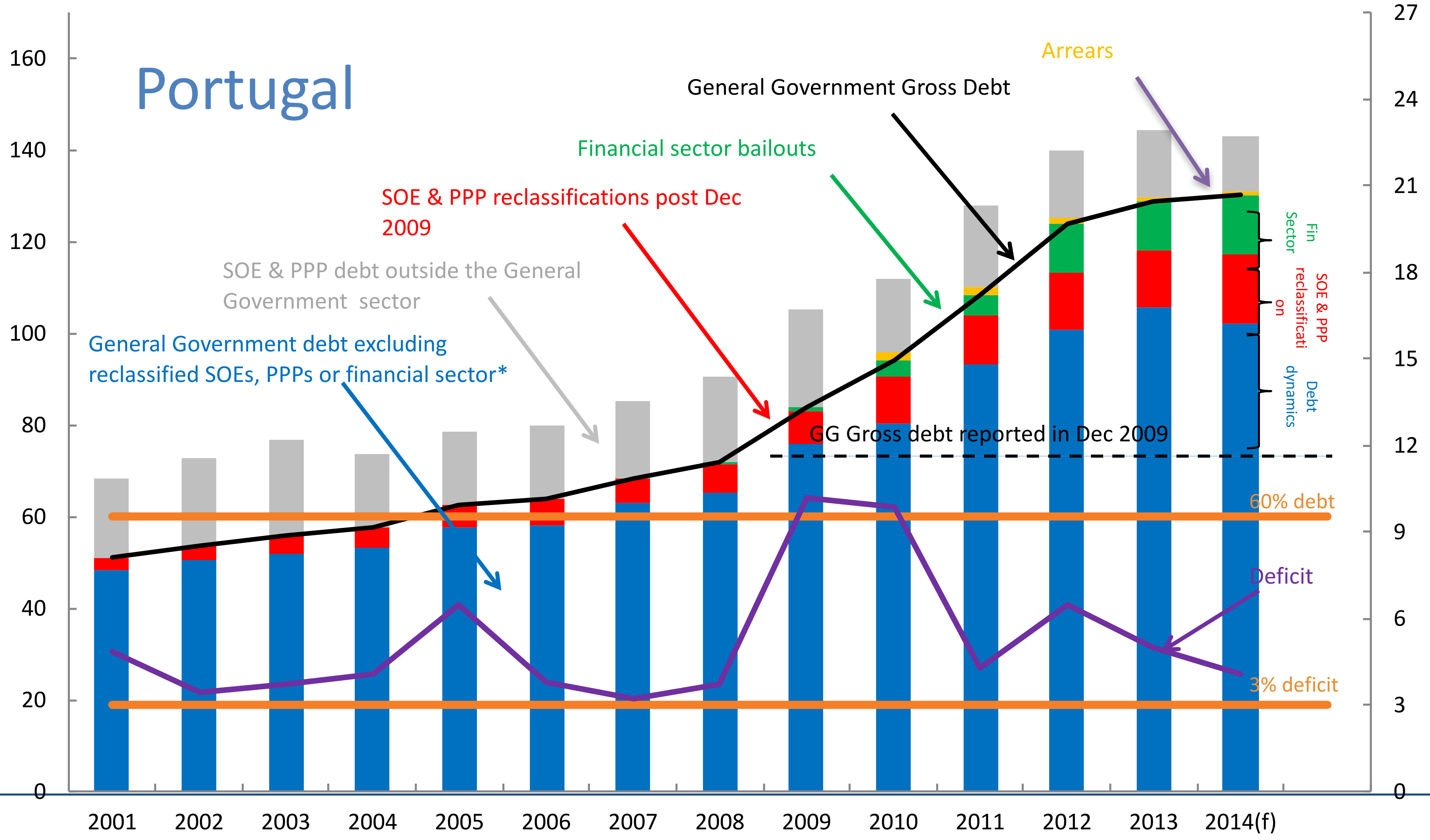
- Preview
- Defining responsibility and transparency
- Why responsibility/accountability now

Part II

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

Preview

Anything that could go wrong did go wrong



Definition(s)

Fiscal Responsibility

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.
  - Very little agreement on what constitutes high-quality government,” Fukuyama, 2013.
  - 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?

Italy—2002 ROSC

https://www.imf.org/external/pubs/ft/scr/2002/cr02231.pdf

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 ant-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)

Issues Revealed by the Crisis

	FRA	DEU	NLD	ESP	PRT	GBR	USA	GRC	IRL	ISL	AVE*
Underlying fiscal position	**1.7**	**3.2**	**-2.4**	**1.8**	**11.3**	**3.7**	**8.1**	**16.3**	**1.3**	**10.9**	**6.0**
Revisions to 2007 deficit & debt	1.7	1.8	-0.9	-0.1	0.1	1.5	7.1	2.5	1.6	4.0	4.7
Changes to government boundary	-0.7	1.4	-0.2	0.6	9.4	1.9	0.9	11.2	-0.1	2.5	1.1
Cash-accrual adjustments	0.7	0.0	-1.3	1.3	1.7	0.3	0.0	2.6	-0.2	4.5	0.2
Exogenous shocks	**8.4**	**12.8**	**14.2**	**15.4**	**8.1**	**17.0**	**6.3**	**40.0**	**60.2**	**39.5**	**9.8**
Macroeconomic shocks	8.3	4.7	5.2	13.0	4.4	8.9	3.8	38.4	35.7	-3.3	6.0
Financial sector interventions	0.0	8.1	9.0	2.5	3.6	8.1	2.5	1.6	24.5	42.8	3.8
Policy changes	**2.3**	**3.8**	**1.9**	**4.9**	**4.7**	**1.1**	**6.4**	**-8.0**	**-9.9**	**-4.3**	**4.7**
Other factors	**2.1**	**-0.3**	**6.5**	**1.9**	**3.7**	**6.2**	**8.3**	**-6.7**	**7.5**	**21.6**	**5.9**
Total Unforecast Increase in Debt	**14.4**	**19.5**	**20.2**	**24.0**	**27.8**	**28.0**	**29.1**	**41.7**	**59.1**	**67.7**	**26.4**

Unreported Deficits

SoEs & PPPs

Arrears

Macroeconomic Risks

Contingent Liabilities

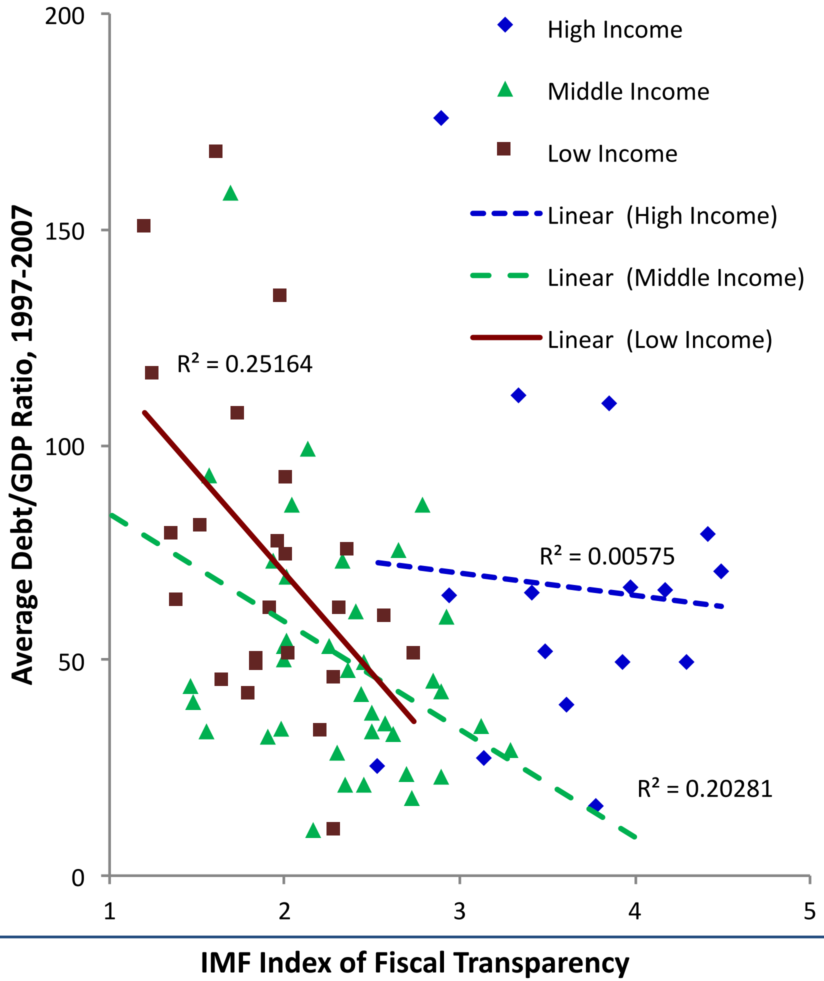
Stimulus / Consolidation

Main lessons

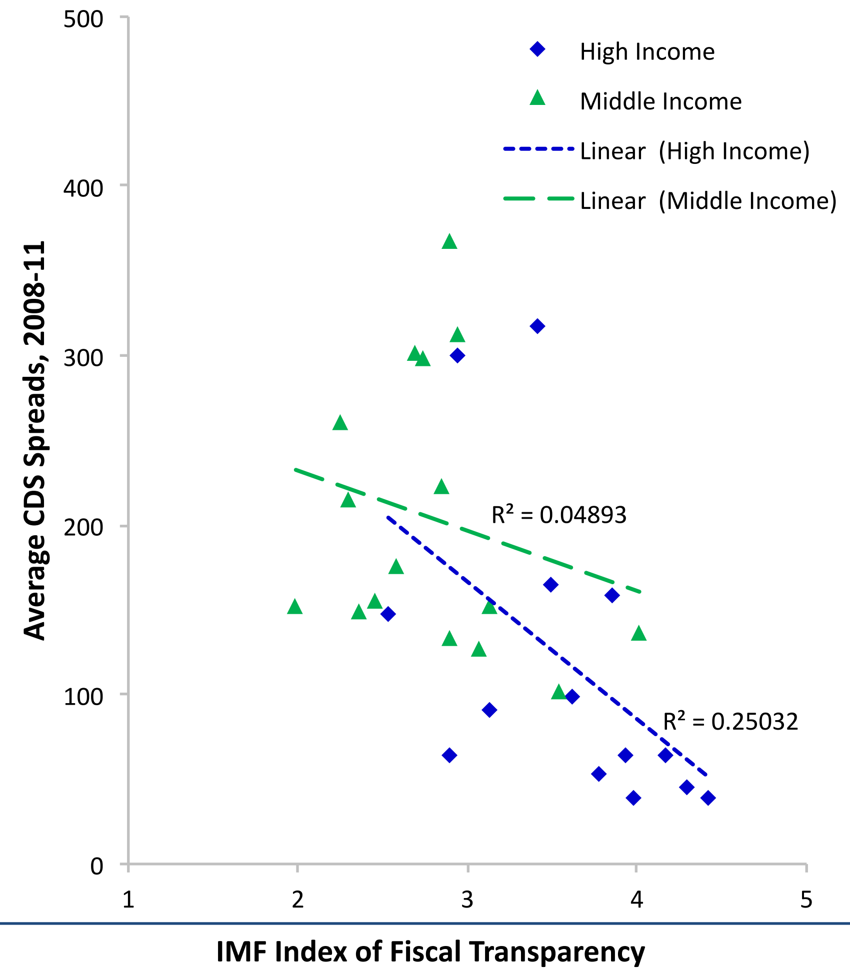
- Countries did not know their true fiscal position.
- Fiscal adjustment turned out to be an illusion as liabilities went undetected and accumulated outside the traditional perimeter of central governments' budgets.
- In other words, there was poor quality information on fiscal developments.
- But financial markets started to care—which could provide further incentives for sound fiscal policies.

Markets seem to care ……

Fiscal Transparency & Fiscal Performance

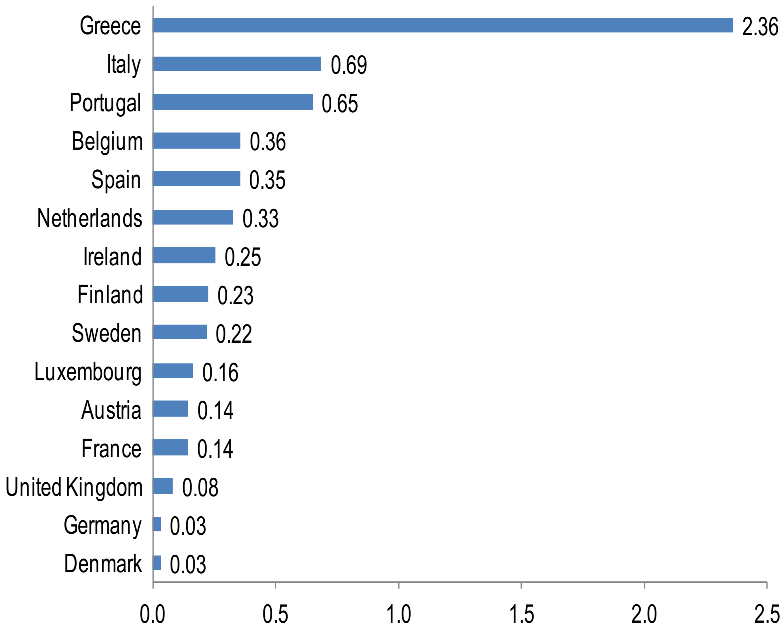


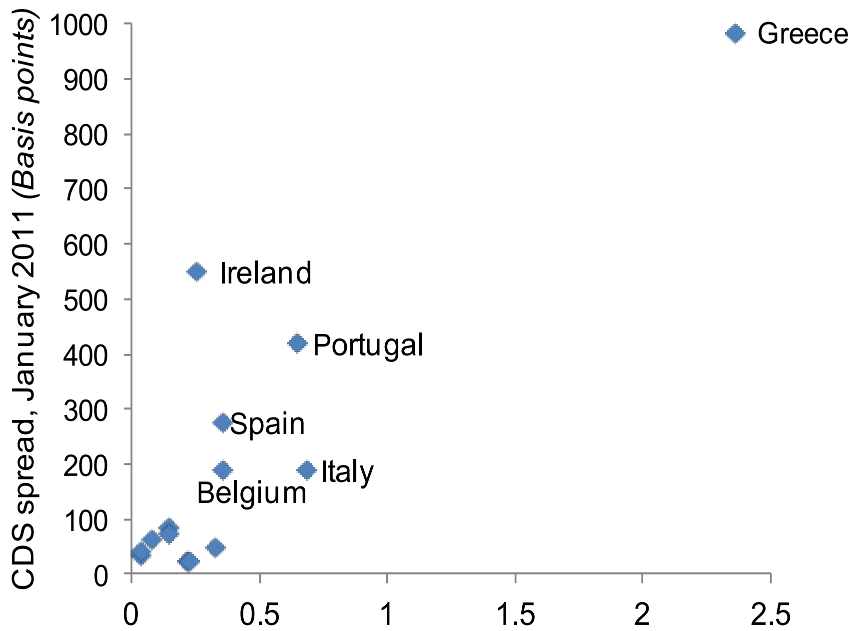
Fiscal Transparency & Fiscal Credibility



……and do not seem to forget

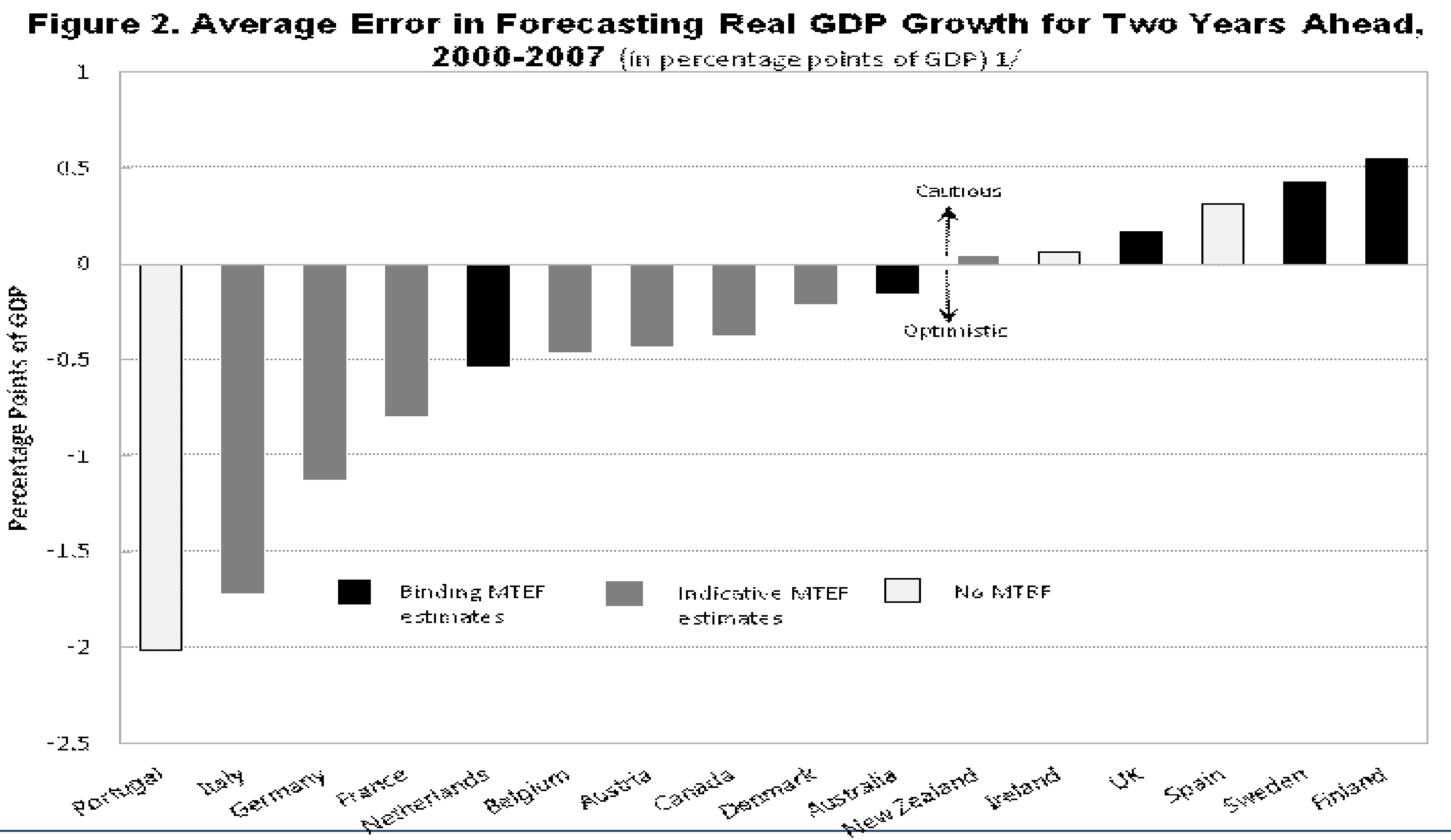
Average Annual Impact of "Fiscal Gimmicks and One-off Measures" in Europe *(1993–2003; Percent of GDP),* **and relationship to CDS Spreads in January 2011**





Source: Koen and van den Noord (2005, Annex Table A1), Bloomberg, Irwin.

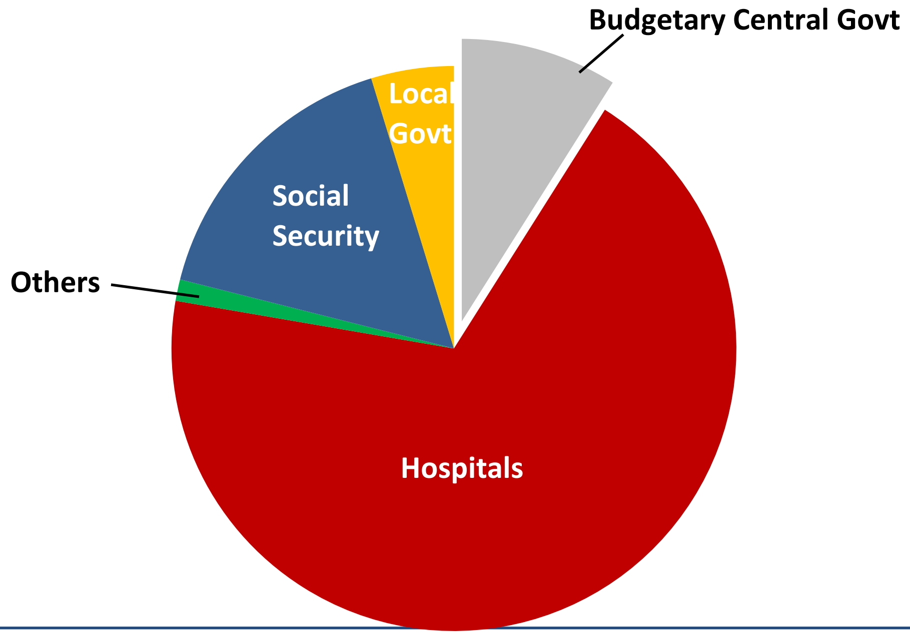
Accurate macro-forecasts



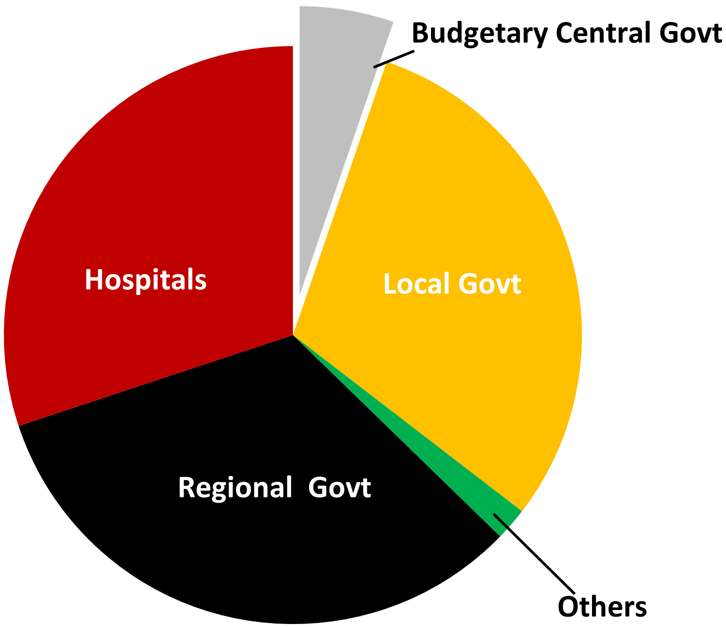
Arrears: execution and reporting failures

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	Weakness in Current Standards	Recommendation
Revisions to Deficits	Infrequent fiscal reporting	Monthly operational fiscal reports
Quasi-fiscal Activity by SoEs	Exclusive focus on general government	Publication of fiscal data for public sector
Unreported Flows	Losses on asset & liability holdings not recognized	Recognition of doubtful debts in summary aggregates
Macroeconomic Shocks	Bias in macroeconomic forecasting	Alternative macro-fiscal scenario analysis
Exposure to Financial Sector	No recognition of contingent liabilities	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

- International Monetary Fund, New Transparency Code and Evaluation, 2014, available at *www.blog-pfm.imf.org/files/ft-code.pdf*

- International Monetary Fund, Fiscal Transparency, Accountability and Risk, Policy Paper, Fiscal Affairs Department, August 2012, *available at:* *www.imf.org/external/np/pp/eng/2012/080712.pdf*

- Irwin, Timothy, 2012, "Accounting Devices and Fiscal Illusions, "IMF Staff Discussion Note SDN/12/02 (Washington: International Monetary Fund).