

Delineating the Public Financial Management Reform – On the Common Mistake of Overestimating the Reform as Universal Remedy and How to Avoid This

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1. The Present Situation of the Public Management Reform

At first glance, the reform process of public financial management seems to be clear-cut and (internationally) consistent. Its aim is to either substitute the traditional input and cash based budgeting and accounting system for an output and accrual based one or to at least amend the former one. Comparative studies nonetheless document that individual approaches do indeed vary. This holds true for international as well as for intranational comparisons, the latter especially being the case in federalist states such as e. g. Germany. For example, the label *Accrual Accounting* allows for a whole variety of approaches to the financial management reform. Major differences have been detected e. g. with regard to the structure and contents of accounting systems, measurement rules, and disclosure requirements (see e. g. Lüder/Jones, 2003).

The increasing international and intranational divergence of the reform process is presently faced with severe criticism. According to these critical voices the major goal should be a worldwide harmonization of accounting systems in order to allow universal comparisons and in the course of this international as well as intranational benchmarking of budgeting and accounting information. This, the criticism goes, is all the more important in a world of growing political, economic and financial interdependencies.

2. Some cause study on the divergences in practice and its effect on the achievement potential of the reform

In fact, however, the mentioned divergences in practice come as no surprise. Rather they are the predictable result of the involvement of various interest groups and their respective expectations towards the reform of public financial management. Thus, the desired outcomes of public financial management reforms will vary depending on whether they are discussed within a global, national or regional context, on different governmental levels and/or for different purposes e. g.

As a logical consequence, the questions and potential solutions that are being discussed under the guise of *Public Financial Management Reform* are manifold and usually deal with very specific aspects. In my opinion, summarizing a too broad range of aspects under one and the same label bears the risk of losing sight or at least blurring the true and original potentials of the reform. Thus, it appears doubtful whether the cry for a universal approach to the reform of public financial management in favor of an international harmonization of accounting systems is in fact a step into the right direction. Rather does the search for generally acceptable systems, rules and standards distract attention from more urgent questions.

2.1 International Public Sector Accounting Standards (IPSAS) – Major problems on the way to world-wide accepted accounting standards in the public sector

See for example the ongoing discussions among IPSAS board members regarding the completion of an Exposure Draft on Social Policy Obligations. They illustrate the difficulties involved in any kind of attempt at harmonization very strikingly. In the first place, a public sector accounting standard must take into account various public sector specifics and therefore may not rely on work already done in the context of IAS/IFRS. All the more a critical point taking into account that the IPSAS use the framework of the IAS and therefore do not possess an own public sector-specific conceptual basis. Secondly, it must take into account differences in legal frameworks, social security systems etc. in countries world-wide. Another concrete example are the statements made by different countries and stakeholders as response on the invitation of the Public Sector Committee (PSC) to comment on the topic dealing with the definition and recognition of non-exchange revenues (including taxes and transfers). Since IAS 18 (Revenue) prescribes exclusively the accounting treatment for revenue arising from the sale of goods, the rendering of services, and the use by others of entity assets yielding interest, royalties and dividends, based on the matching-principle, the development of IPSAS 9 (Revenue from Exchange Transactions) went smoothly. Now since the majority of the revenues of public sector entities arises from non-exchange transactions including taxes (direct and indirect), grants from national governments, other levels of government, and international agencies, fines, penalties and forfeits, fees and charges (some fees and charges may be exchange revenue), and gifts and donations e. g. a modified adoption of an existing IAS was impossible and a self-contained standard needed to be created. The discussion process leading to the release of the Exposure Draft required more time with a good deal more disagreements needed to be sorted out in comparison with other IPSAS. Always bearing the risk to reduce the standards to a common denominator in order to reach a consensus. Thus e. g. offering choices with regard to the application of measurement rules, especially not meeting the expectations of the citizens to obtain a transparent and fair view of government financial information

2.2 Defining the basis of consolidation

Another prime example concerns the question how to define public services at large or more specifically public core competences. These questions usually pop up when decisions on potential privatizations are to be made. The answers to these questions may vary not only from country to country, but just as well from federal level to federal level within one and the same country. Also, different political parties may hold diverging views on this. Thus, it becomes obvious once more that generally valid classifications are very difficult to reach.

For instance, before Public Financial Management will be able to unfold its potential of giving a true and fair view of the financial situation of a local, regional or national authority, a decision must be made which entities shall and which shall not be included in the consolidation. This is not an easy question to be answered considering the fact that the old dichotomy between public vs. private entities is no longer sufficient to depict an increasingly complex reality. As Jones puts it very adequately: “The basic dilemma [...] is between adopting the criterion of ‘ownership’, which might produce a legal determination, or the criterion of ‘control’, which might produce an economic one; in practice a more radical approach might be to use the extent to which an entity is financed by taxation – however it is owned and controlled – to make the judgement about consolidation.” (Jones 2006, p. 9)

The more public services are provided by decentralised state-owned enterprises or in PPP-constellations external loans and loan guarantees increase. With the state still taking

responsibility for these decentralized units,¹ even in the case of deceptive business acts carrying risk, the need for further consolidating budget and making the linkages more explicit is apparent. As Ruffner/Wehner/Witt (2005, p. 53) put it in their paper on Budgeting in Romania: “In a system with large external loans and loan guarantees and explicit and implicit budgetary relations with State-owned enterprises, more reporting is needed on contingent liabilities.”

In a nutshell the search for detailed answers to specific questions on the one hand, cure-all remedies prescribed by management-consultants (usually experts on the private, not the public sector) and degrees of freedom within the applied systems and standards (a tribute to the alleged necessity of finding some sort of consensus at all?) on the other hand, leave those who were originally supposed to benefit from the reforms (i. e. citizens as well as public managers) unsatisfied.

3. Establishing a theoretical basis for Analysis: Principal-Agent-Theory

The principal-agent-theory provides a promising theoretical framework to explain the governance problems as they presently occur in the public sector. These problems have intensified due to an increasing organizational decentralization and cooperation with private sector organizations (so-called public-private partnerships). The principal-agent-theory helps to understand and explain why the principal-agent-constellations and -problems are more complex in the public than in the private sector. With the citizen as principal 1 (P1) deciding to elect that candidate (Agent 1), who is from P1's point of view the most competent to supply its wants. A1 (respective the parliament) now turns into P2 and mandates the public authorities to meet P1's demands. Within the public authorities there are manifold more principal-agent-constellations until the demand of P1 reaches finally the agency-institution (hopefully) carrying out the task as wanted. These manifold principal-agent-relations bear room for information-asymmetries and therefore establishing the possibility of moral hazard, hidden characteristics, hidden action, hidden information – all of them well-known and analyzed by the principal-agent-theory. Since the governance problems resulting from information-asymmetries due to much more complicated principal-agent-constellations than in the private sector other/additional “public-sector-specific” instruments are required to cope with these problems. The world-wide serious discussions on establishing a Corporate Governance-Code for the public sector underline the problems stated above. Those discussions need to and do take into account that especially the sanction mechanisms via the capital-market do work effectively in the private but not in the public sector: the citizen as public-stakeholder providing the public sector with capital by paying taxes to finance public services has rarely a chance to sanction the public authority e. g. by reducing his tax amount in order to show his discontent.

4. Conclusion and outlook

Many of the reform steps that have been taken up to now do in fact work counterproductive. This can mainly be observed in boosting debts and governance-problems with citizens losing more and more confidence in their governments. Based on my findings, I come to the conclusion that an internationally harmonized governmental accounting is not a realistic perspective in the short run. The efforts that are being taken to create an internationally harmonized governmental accounting may lead to further steering problems and to increasing financial crises within individual countries due to choices being offered with regard to the application of measurement rules. Also the fact that the international language of accounting is English may lead to further problems on the national as well as the international level. In the first place this may simply lead to problems in communication. However this is more than a matter of vocabulary. Rather, polarised ways of thinking about accounting systems (with the Anglo-American view at the one extreme and the continental European view on the other) (Jones 2006, p. 5), are the result of differing cultural traditions.

¹ e. g. over 50% of the credits raised by German local authorities are used for debt redemption of decentralized public units.

The emphasis of *Public Financial Management Reform* over the last decades has tended to be more technique-driven concentrating on budgeting techniques, and the development of output measures than on changes on the organisational and personnel structure and processes (Lüder 1998, p. 126). Further elaborations need to be mainly discussed in a cultural and not technique-driven context of financial management reforms. Therefore, the following aspects will be of major relevance for the future and the quality of reform-outcomes with regard to outcome and impact-measures:

- (1) Organizational learning (learning from experience – between countries and also between different federal levels within one country) must no longer be neglected in public financial management reforms. Had it been taken into consideration from the beginning on, it would have led directly to the detection of differences in the organization of reforms attributable to differences in culture. It would have opened the opportunity to benefit from mutual experiences. Time as well as money could have been saved within the reform process and last but not least organizational learning might have paved the way for harmonization. Therefore, organizational learning must play a major role in the ongoing reform process.
- (2) The sole focus on technical reform aspects is insufficient. Leaving organizational and personnel structures unchanged as well as letting civil servants be overrun by technically complex accounting systems implemented by consulting and software enterprises is a major source of failure. Therefore the focus must be shifted from technical to cultural aspects.
- (3) Among the main aspects to be discussed will be the need for changing the legal frameworks in order to let the up to now purely technical systems unfold their effectiveness. This is an important point since the legal framework reflects and determines the different views of the state and its institutions.

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