

Public Financial Management is a Process to Improve

Public Financial Management is a Process to Improve Government Financial Performance and Position (Not a Bureaucratic Accounting Project)

Public Financial Management

- ▶ Significant improvements in government financial performance and position cannot occur unless all the system components use common measures of what constitutes financial performance and position, as defined in internationally agreed upon public sector accounting standards: (i) financial management decision-making—align revenue decision with expenditure decisions, (ii) fiscal objectives for performance and position, (iii) the budgetary process, (iv) legislative appropriations, (v) financial reporting and (vi) external audit.
- ▶ Without all the system components being based on a set of common measures, incentives will be unclear and inconsistent, decision-making will be confused, accountability will be weakened, and performance will necessarily suffer as a result.
- ▶ For example, using resources to produce a service (one aspect of performance) is not the same as using them to acquire an asset.

How Does the State Reform? Examples of Using the “Public Financial Management”

Public Financial Management

Improving Decision-Making:

- ▶ Allow decision makers to see the economic reality of complex financial transactions and decisions;
- ▶ Provide insights into prospective liabilities;
- ▶ Assist in ranking financial impact of various alternatives;

Improving Results:

- ▶ Provide accurate information to better manage financial and fixed assets;
- ▶ Increase the efficiency of public finance decisions: less costs, less

Portugal to Become the 1st station in the World to Implement the Public Financial Management

Public Financial Management

Adopt International Accounting for Decision-Making, Fiscal Objectives, Budgeting, Appropriations, Reporting, and External Audit

Portugal implements the Public Financial Management, which includes accrual accounting as specified in internationally agreed upon public sector accounting standards (IPSAS), to improve financial performance and position.

Public Financial Management

1. Use for decision-making in measuring impact on consolidated financial statements;
2. Legal specification that the fiscal objectives of the government include net worth, operating balance, revenues, expenses, and net debt, all of which comply with internationally agreed upon public sector accounting standards;
3. Specify its planned financial performance and year-end position on an IPSAS basis (i.e. budget on an accrual basis);
4. Formalize accrual-based financial plans in parliamentary appropriations (i.e. gives the accrual budget numbers legislative force); and
5. Report on an IPSAS basis in its financial statements at year-end, including reporting against budget and appropriations; and
6. Auditing an IPSAS based financial statement will improve government trust and confidence.

The Public Financial Management Approach

Illustrative Examples

Cash Flow Focus vs. PFM Focus

Illustrative Examples

Seven illustrative examples highlighting the financial impact and consequences using a cash flow focus versus a PFM focus (sources of funds from borrowing):

Asset Management:

1. Impact of Proper Real Estate Valuation
2. Impact of Increase in Value of Assets Prior to Sale
3. Impact of Financial Assets Appreciation
4. Impact of Investment in Bank Holding Company
5. Impact of Government Investment in Commercial Enterprise

Liability Management:

6. Impact of Correct Valuation of Debt
7. Impact of One Year Retirement Age Increase

1. Cash vs. PFM Decision-Making

Impact and Consequences of Proper Real Estate Valuation

- ▶ Illustrative example of fair valuation of real estate resulting in increase of €12.5bn.

| | Cash Flow Focus | PFM Focus |
|--------------|--|--|
| Impact | <p>Debt: No impact Fiscal Balance: No impact</p> | <p>Net Worth: Increase €12.5bn Assets: Increase €12.5bn Net Debt: No impact Debt: No impact Fiscal Balance: No impact</p> |
| Consequences | <ul style="list-style-type: none"> ▶ Asset deterioration ▶ Missed opportunities ▶ Encourage mismanagement | <ul style="list-style-type: none"> ▶ Win trust and confidence with PFM ▶ Asset appreciation with better ▶ Reduce expenditures |

2. Cash vs. PFM Decision-Making

Impact and Consequences of Investment and Increase in Value of Non-Financial Assets Prior to Sale

- Illustrative example of an investment of €5bn and an appreciation of €1bn

| | Cash Flow Focus | PFM Focus |
|--------------|--|--|
| Impact | <p>Debt: Increase € 5bn Fiscal Balance: Decrease € 5bn</p> | <p>Net Worth: Increase € 1bn Assets: Increase € 6bn Net Debt: Increase € 5bn Debt: Increase € 5bn Fiscal Balance: No impact</p> |
| Consequences | <ul style="list-style-type: none"> ➤ Asset deterioration ➤ Missed opportunities ➤ Encourage mismanagement | <ul style="list-style-type: none"> ➤ Win trust and confidence with PFM ➤ Asset appreciation with better ➤ Reduce expenditures |

3. Cash vs. PFM Decision-Making

Impact and Consequences of Financial Assets Appreciation

- ▶ Illustrative example of an appreciation financial assets by €6bn.

| | Cash Flow Focus | PFM Focus |
|--------------|--|---|
| Impact | <p>Debt: No impact Fiscal Balance: No impact</p> | <p>Net Worth: Increase € 6bn Assets: Increase € 6bn Net Debt: Decrease € 6bn Debt: No impact Fiscal Balance: No impact</p> |
| Consequences | <ul style="list-style-type: none"> ▶ Asset deterioration ▶ Missed opportunities ▶ Encourage mismanagement | <ul style="list-style-type: none"> ▶ Win trust and confidence with PFM ▶ Asset appreciation with better ▶ Reduce expenditures |

4. Cash vs. PFM Decision-Making

Impact and Consequences of Investment in Bank Holding Company (Financial Asset)

- Illustrative example of an equity investment of €2bn and an appreciation of financial assets by €1bn.

| | Cash Flow Focus | PFM Focus |
|--------------|--|--|
| Impact | <p>Debt: Increase € 2bn Fiscal Balance: Decrease € 2bn</p> | <p>Net Worth: Increase €1bn Assets: Increase € 3bn Net Debt: Decrease € 1bn Debt: Increase € 2bn Fiscal Balance: Increase € 1bn</p> |
| Consequences | <ul style="list-style-type: none"> ➤ Asset deterioration ➤ Missed opportunities ➤ Encourage mismanagement | <ul style="list-style-type: none"> ➤ Win trust and confidence with PFM ➤ Asset appreciation with better ➤ Reduce expenditures |

5. Cash vs. PFM Decision-Making

Impact and Consequences of Government Investment in Commercial Enterprise

- Illustrative example of government investment of €3bn in a commercial enterprise.

| | Cash Flow Focus | PFM Focus |
|--------------|--|---|
| Impact | <p>Debt: Increase € 3bn Fiscal Balance: Decrease € 3bn</p> | <p>Net Worth: No impact Assets: Increase € 3bn Net Debt: Increase € 3bn Debt: Increase € 3bn Fiscal Balance: No Impact</p> |
| Consequences | <ul style="list-style-type: none"> ▶ Asset deterioration ▶ Missed opportunities ▶ Encourage mismanagement | <ul style="list-style-type: none"> ▶ Win trust and confidence with PFM ▶ Asset appreciation with better ▶ Reduce expenditures |

6. Cash vs. PFM Decision-Making

Impact and Consequences of Valuation of Debt

- Illustrative example of correct valuation of debt under internationally agreed upon accounting standards.

| | Cash Flow Focus | PFM Focus |
|--------------|--|--|
| Impact | <p>Debt: No Impact (€241bn; 131% of GDP) Fiscal Balance: No Impact</p> | <p>Net Worth: Increase € 22bn Assets: No Impact Net Debt: Decrease € 22bn (€ 146bn; 79% of GDP) Debt: Decrease € 22bn (€219bn; 119% of GDP) Fiscal Balance: No Impact</p> |
| Consequences | <ul style="list-style-type: none"> ➤ Overstate debt ➤ Borrowing on less attractive terms ➤ Lower credit ratings | <ul style="list-style-type: none"> ➤ Win trust and confidence with PFM ➤ Better borrowing terms ➤ Higher credit ratings |

7. Cash vs. PFM Decision-Making

Impact and Consequences of One Year Retirement Age Increase

- Illustrative example of a decrease of €2bn in pension liabilities resulting from an increase of 1 year in retirement age starting 3 years from time of decision.

| | Cash Flow Focus | PFM Focus |
|--------------|--|--|
| Impact | Debt: No impact Fiscal Balance: No impact | Net Worth: Increase € 2bn Assets: No impact Net Debt: No Impact Debt: No Impact Fiscal Balance: Increase € 2bn |
| Consequences | <ul style="list-style-type: none"> ➤ Hide liability exposure ➤ Missed opportunities ➤ Encourage mismanagement | <ul style="list-style-type: none"> ➤ Win trust and confidence with PFM ➤ Asset appreciation with better ➤ Reduce expenditures |