Conselho das Finanças Públicas

Sustainability, Risks and Public Financial Management

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Topics covered

SUSTAINABILITY IN PUBLIC FINANCES

RISKS TO PUBLIC FINANCES SUSTAINABILITY

PROMOTING SUSTAINABILITY THROUGH THE PFM SYSTEM

Sustainability in Public Finances: what is it ?

In a **broader sense**, sustainability can be characterized as “development that satisfies the adequate provision of goods and services to the present generation, without compromising the ability to provide for future generations under equivalent conditions”.

(United Nations General Assembly, 1987, p. 43)

In the field of **public finances**, sustainability can be seen as the ability to ensure that situations of insolvency of general government are avoided, enabling the State to honor commitments towards citizens and creditors, ensuring adequate provision of goods and services to the present and future generations.

Different definitions of sustainability (flows or stock of public debt)

European Central Bank (ECB)

Defines public debt sustainability as the ability to service accumulated debt at any time, which implies:

Solvency: compliance with the government's intertemporal budgetary constraint, i.e., the discounted value of primary balances expected in the future must be equal to or greater than the current value of public debt;

Liquidity: a short-term concept related to the government's ability to maintain access to financial markets, ensuring financing that allows it to carry out the repayments of contracted debt (principal and interest) and that covers any additional needs arising from the economic cycle.

European Commission (EC)

Approaches sustainability of public finances as the ability of a government to sustain its current spending, tax and other-related policies in the long run without threatening its solvency or defaulting on some of its liabilities or promised expenditures.

Different definitions of sustainability

International Public Sector Accounting Standards Board (IPSASB)

Dimensions of Fiscal Sustainability (2011):

Fiscal capacity: ability to meet financial commitments as the servicing and repayment of debt and liabilities

Service capacity: maintain services at the volume and quality provided to current and future recipients)

Vulnerability: fiscal dependency upon funding sources outside vs power to vary/create new sources of taxation and revenue.

Fiscal capacity and service capacity involve consideration of the capacity of entities to finance future obligations without increasing taxation levels.

Reporting on the Long Term Sustainability of an Entity's Finances (2013):

RPG1: information on impact of current policies and decisions made at the reporting date on future inflows and outflows, supplements information in the financial statements.

Provides indication of the projected long-term sustainability of an entity's finances over a specified time horizon in accordance with stated assumptions.

Long-term fiscal sustainability is defined as the ability of an entity to meet service delivery and financial commitments both now and in the future.

Economic Perspective

Why do we need PF Sustainability?

Public finances represent a large part of national economies, funded by taxation and borrowing.

Taxes interfere with the disposable income of households and the investment of companies, thus influencing economic growth.

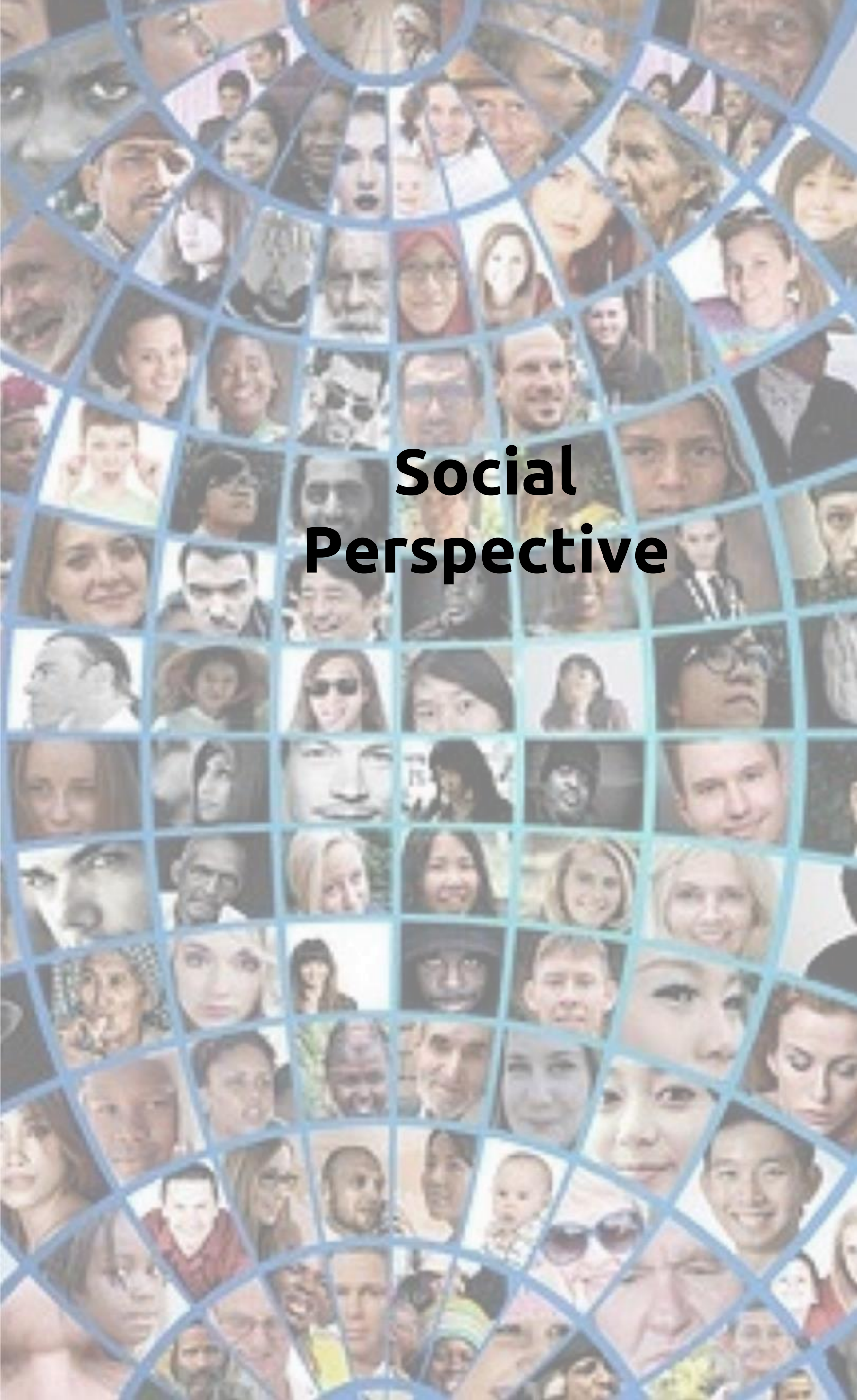
Difficult access to market financing has a significant negative impact on economic growth, making it difficult to service debt.

Public investment can increase economic growth and potential output.

Public expenditure (social expenditure and education) influences productivity potential.

Safeguards fiscal space to accommodate possible adverse macroeconomic shocks.

Why do we need PF Sustainability?



Social Perspective

Taxes and social benefits interfere with the disposable income and living standards of households.

Public expenditure (social expenditure and education) influences the population’s well-being.

Safeguards the ability to formulate consistent and appropriate policies to deal with efficiency and social goals and intergenerational fairness.

Why do we need PF Sustainability?

Tax policy can protect the environment.

Public expenditure/investment is needed to deal with climate change.

Safeguards the ability to implement appropriate policies to deal with objectives of reducing the impact of climate change on the economy and the society, preserving biodiversity.

What are the risks to PF sustainability?

Risks are a measure of uncertainty as to the possible deviation from the expected result of a variable, which may take a positive or negative value. Fiscal risks can cause budget revenue or expenditure to deviate from expectations or forecasts (IMF, 2009).

Type of risks:

Short/Long term risks

Macroeconomic risks

Fiscal risks

Social risks

Climate risks

What are the risks to PF sustainability?

Macroeconomic Risks related to Potential GDP, Long Term Growth and Economic Cycles

Cyclical fluctuations in GDP have a direct impact on public finance by means of the automatic stabilisers.

Discretionary policies, imply fiscal space.

Potential GDP level and growth depend on capital stock, labor force and total factor productivity, reflecting:

- Demographic changes, Employment,
- More/better capital, quality of the labor force,
- Capital intensity and accumulation.

What are the risks to PF sustainability?

Fiscal Risks related to Public Revenue

Potential output is crucial for tax revenue in the long-term.

Effectiveness of the tax system and tax gaps.

Tax base and concentration of tax revenue on few taxpayers.

Tax base erosion from behavioural, technological or demografic changes.

Ability to implement revenue measures and possible deviations.

Forecasting accuracy.

What are the risks to PF sustainability?

Fiscal Risks related to Public Expenditure

Expenditure developments are mostly dependent on past choices as to the provision of public goods and services and social transfers.

New policy measures adopted and possible impact deviations.

Contingent liabilities:

- formal commitments: guarantees, public-private partnerships or labilities from financial sector, nonperforming loans.
- informal liabilities involving considerable degree of public commitment such as liabilities taken on by public corporations.

Debt servicing from normalization of monetary policy.

Forecasting accuracy.

What are the risks to PF sustainability?

Social Risks related to Public Expenditure

Demographic challenges: rising life expectancy, low birth rates and migration.

Impact of ageing population:

- Welfare spending (pensions)
- Health and social care

Inflation pressures cost of living updates in social spending.

Long-run trends threaten to progressively erode fiscal sustainability directly (tax bases and spending) or indirectly (overall performance of the economy).

What are the risks to PF sustainability?

Climate related risks

Climate change-related phenomena are expected to have substantial ecological, social, economic and fiscal impacts.

Temporary (e.g., adverse weather events) or more persistent (gradual transformation of the environment).

Macroeconomic impact of climate risks:

- Supply side (productive capacity of the economy and its components such as labor, physical capital, natural resources, and technology) and
- Demand side (private and public consumption, investment and foreign trade).

What are the risks to PF sustainability?

Fiscal impact of Climate related risks

Impacts on the value of assets and financial obligations due to:

- Physical risks – direct costs from extreme weather events;
- Transition risks – policies to mitigate and adapt to the effects of climate change.

Public investments and public debt from structural policies underlying the process of mitigation and adaptation.

Magnitude of risks depends on climate change developments, and mitigation strategy, whether the transition to a decarbonised economy takes place in an orderly manner or not.

How can PF sustainability be improved?

Minimizing risks depends on the quality of the budgetary process and the articulation between fiscal policy and sectoral policies.

Structural and fiscal reforms can increase potential GDP growth in the long run and thus promote sustainability. Important to identify relevant fiscal reforms that create fiscal space.

How can PFM support PF sustainability?

- Risk Management
- Tackling sustainability challenges
- Improving fiscal frameworks
- Improving transparency
- Improving efficiency and effectiveness of public policy
- Supporting inclusive and sustainable growth

Public Financial Management

What is Public Financial Management (PFM)?

Processes and procedures available to governments wanting to secure and use resources effectively, efficiently and transparently. It covers all aspects of managing public resources, including resource mobilization and debt management, with a progressive extension to the medium to long term implications and risks to public finances from today's policy decisions (Cangiano, 2013).

PFM systems establish the link between policies and operational processes, covering information, processes and rules that support fiscal policymaking and provide instruments for its implementation.

What PFM tools support PF sustainability?

Key Objectives of PFM

Objective	Tools
Maintaining sustainable fiscal position	Fiscal rules and frameworks, long-term sustainability projections, baseline estimates, fiscal risk analysis, statements of contingent liabilities and independent fiscal assessments and projections.
Effective allocation of resources	Medium-term budget frameworks , strategic planning, program budgeting, investment programs, spending reviews .
Efficient delivery of public goods and services	Performance budgeting, reporting and audits, accrual accounting, internal control, integrated financial information systems.

Linking PFM dimensions and tools to PF sustainability

Key Objectives of PFM[1]

- Maintaining sustainable fiscal position
- Effective allocation of resources
- Efficient delivery of public goods and services

PFM tools can improve Transparency, Policy Outcomes and Accountability

Transparency and comprehensiveness:

Raises political costs of unsustainable policies

Strengthens enforcement of fiscal rules

Promotes accountability

Improves market access and reduces borrowing costs

Linking budgeting, planning and policy:

Improves policy target and outcomes

Better allocation and spending to support inclusive and sustainable growth

Applying specific lens to the budgetary process

Control, oversight and accountability:

Improves quality of procedures in place to guarantee compliance of existing rules

Promotes accountability in the use of public resources.

[1] Cangiano (2013)

Budgeting for PF Sustainability

Specific lens for Green, Gender Equality and SDG goals:

Better managing for PF sustainability

Risk Management

Dealing with many uncertainties: predictability increases with the stability of national/international economic and social environment.

Managing budgetary risks: sense of internal and external threats.

Risk management identifies:

- Risks and the possible impacts on budgetary variables and strategies to reduce probability of occurrence or mitigate their impact;
- Provides information on the degree of vulnerability of public entities and the public sector to the concentration of certain risks;
- Involves line ministries (better perception of risks in their business areas);
- Prepares public finances to deal with sources of slow-building pressure.

Managing for PF sustainability

Accrual accounting	High-quality transparent information. A good set of public accounts can contribute to a stronger understanding of public finances and better choices about taxes and public spending. Provides a framework for systematically identifying existing liabilities, and potential and contingent liabilities. Comparable data with private sector financial reporting and reconciles to the National Accounts which underlie fiscal rules in the EU. Alternative indicators of deficit and debt can reveal fiscal problems not highlighted by headline measures from National Accounts.

Auditing for PF Sustainability: what role?

Increasing importance of Environmental Social and Corporate Governance (ESG) requirements and growing pressures towards net zero: will trends in the private sector reporting eventually reach the public sector?

Will non-financial reporting in GG change the role of audit: beside operating effectively and efficiently public agencies will also have to operate fairly and sustainably?

Can these dimensions be combined efficiently and in a sustainable manner in public management?

Challenges ahead

Governments have been facing and adjusting to new and more intense challenges.

The role of government as a buffer has been expanding in the last years. Public debt levels are high and rising interest rates may mark an end to the era of low borrowing costs.

Concerns over the climate crisis are growing in the international arena. Wars and international tensions are putting pressure on military spending.

Challenges ahead will require sizeable adjustments.

How will governments prioritize the many demands that emerge in this ‘poly-crisis’ and maintain sustainable finances?

Challenges ahead

Control of public finances is a requirement for building long-term resilience and fiscal sustainability.

Institutional factors such as the quality of the PFM system and the budgetary framework improve public expenditure planning and execution, and fiscal results.

Good governance depends on timely high quality data and the capacity to master PFM tools for tracking and tackling risks.

Promoting Transparency, Accountability and Good Governance are essential to support sustainability of public finances.

Independent checking on timeliness, accuracy of financial information and systemic weaknesses of the PFM system are therefore important contributions.

Conselho das Finanças Públicas

Thank you.