Towards predictability and sustainability of public finances: a commentary on 'Control of the Central Government Budget Outturn'

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Towards predictability and sustainability of public finances: a commentary on 'Control of the Central Government Budget Outturn' ♣

By RUI NUNO BALEIRAS♥

2 October 2014

The *Fridays of Reform* Organising Committee have kindly asked me to comment on the talk given by Orlando Caliço in the session that took place on 4 April 2014, entitled "Control of the Central Government Budget Outturn". This essay was born from the notes that I made at the time and its analytical object is the main speaker's presentation which is available on the event's website—hereafter be referred to as Caliço (2014). The paper benefited from the normative principles put forward in the meantime by Cardoso (2014) to redesign the Portuguese budgetary process; it is aligned with such framework and the suggestions below complement those proposed by the Chair of the Portuguese Public Finance Council.

1 Introduction

It was impossible to refuse the organisers' challenge, because of both the presenter and the topic's social relevance and timeliness. From Orlando Caliço I learnt, in the early stages of my career, the usefulness of getting in touch with reality before theorising on top of it. The ideas set out in Caliço (2014) are precious and deserve the undivided attention of all those concerned with finding solutions to the conjunctural, and above all structural, problems that public finances face in Portugal. The current position has made it even clearer and urgent to rethink budgetary control in the public institutions. This concern stems, basically, from a statistical regularity that impacts on Portugal and many democracies: **deficit bias**.

While the sum of all future budget balances is tied to the current level of debt,[1] the endless life of the government provides for long periods of surplus or deficit. Following on from earlier works, Wagner (2012) recalls evidence from the 20th century which shows that deficit periods are longer than surplus ones, a regularity pointing towards the notion of deficit bias. This phenomenon has been studied theoretically and econometrically in the political economy literature, and a number of explanations have been given for its presence in democratic nations. Those explanations include among others: taxpayers' illusion with respect to the cost of the public provision of goods and services [a school of thought that began with Buchanan and Wagner (1977)], intertemporal

♣ This Occasional Paper is the pre-publication version of a chapter in a book that the institutional organisers of the "Fridays of Reform" initiative plan to launch in December 2014.

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[1] The intertemporal public budget constraint states that for debt to be sustainable the sum of present values of future primary balances must be sufficient to pay the current level of debt.

inconsistency of policies in the absence of credible incentives [Kydland and Prescott (1977)], the asymmetry between beneficiaries and contributors of public expenditure [also known as the problem of common budgetary resources; von Hagen and Harden (1995)], prisoners' dilemmas [concrete political circumstances that undermine a Government's internal cohesion and destabilise co-operative solutions between competing platforms, either within coalitions or within single party governments—Edin and Ohlsson (1991) and Hallerberg and von Hagen (1999), respectively].

Whilst markets believe in the debtor's ability to service the debt, borrowing goes smoothly and relatively long periods of deficit and debt accumulation are possible. The problem bursts when that confidence ceases; then the price becomes prohibitive and there is a more or less abrupt halt to credit. In other words, the market has identified the *unsustainability* of public debt. In these circumstances, adjustment becomes imperative and it is performed in a harsh manner since it has to produce results in a short time. Budget consolidation measures follow one after the other causing collateral damage to the economy and budget policy becomes *unpredictable* and ceases to be a reliable anchor for securing households' and businesses' expectations, worsening recessions and the social dramas usually associated with them. The correction is even more painful when on top of the imbalance in the public account there is an imbalance in the external account, especially in countries deprived of other conventional corrective tools such as the exchange rate and the interest rate.

This is the background for this article. There are institutional features of the budgetary process in democratic countries that bias budget balances towards deficits. However, the good news is that it is possible to contain these vectors by means of a suitable revision of the institutional architecture. That revision should aim at ensuring sustainable and predictable public finance paths. This is the only way to guarantee the exercising of democratic alternation in economic and fiscal policies. Although the specific reasons for that bias are common to many nations, it is fair to say the causes should be diagnosed and remedied within each one's particular institutional context.

Therefore, it is appropriate to ask if the key to eliminate this bias in Portugal is to be found in improved control of revenue and public services outturn, which lies at the heart of Caliço (2014). My answer is yes but it is not enough to control the budget outturn in order to achieve that goal. In order to explain my position I must begin by placing the budget outturn itself into perspective, that is to say, compare it to the other stages of the so-called budgetary process, as explained in Section 2. However, any changes made to control mechanisms—such as the duty to provide new reports and the publishing of outturn results as proposed by Calisto (2014)—that are unaccompanied by changes to other aspects of the budgetary process will make little or no contribution to a sustained reduction in the public budget imbalance. Furthermore, as I will note later, they may cause the opposite effects on this front.

It is my conviction that Portugal requires an integrated and holistic approach to the budgetary process. More than control, the country needs a public finance management system. Section 3 describes briefly the main components of this change in paradigm. The suggestions made in Caliço (2014) touch on a number of these components. It is from this standpoint that I make some comments in Section 4 on the contents of Orlando Caliço's proposals. The article comes to an end in Section 5 with a series of final remarks.

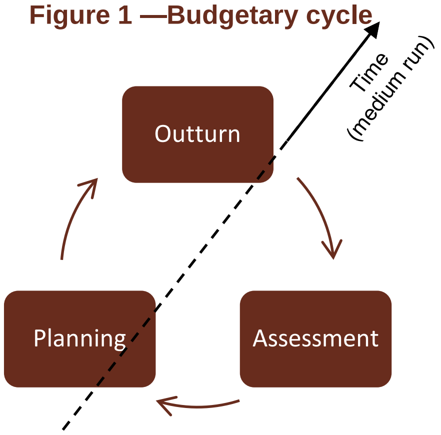
2 The budget outturn

The quality of the budget outturn, at both the aggregate and the service levels, neither begins nor ends with the incurring of expense or the recognising of revenue, that is to say with its actual outturn. It depends on the budgetary procedure in which it takes place. In a very broad sense the **budgetary procedure** is the institutional framework in which the collective choices as to the allotting of a society's common resources are shaped and enacted. Following the definition given by Cangiano *et al.* (2013, p. 6), that framework incorporates "the laws, the procedures, the rules and conventions, including the organisations defined by those elements, which influence the direction and management of budgetary policy".

2.1 Budget outturn and budget cycle

For the purposes of this section it is sufficient to highlight three phases of the budgetary process: planning, outturn and assessment (see Figure 1). A few normative principles should be met at each stage. In a budgetary process designed to ensure public finance predictability and sustainability the three phases must be linked over the medium-term, a period that may or may not coincide with the parliamentary term. This linkage is equally helpful to the effectiveness of public policy in general.

Figure 1 —Budgetary cycle



The figure sets out to illustrate the notion that the budget outturn is part of a cycle, the budgetary cycle. In a first instance we have the planning phase. It begins with a diagnosis of the country's economic and fiscal position, followed by the defining of the medium-term economic strategy and the devising of the fiscal strategy best suited to achieving the targets of the former. The country's decision, through the political system, on the public expenditure level it is ready to pay, that is to say, its identification of the overall public budget constraint, should follow from the linkage between those two strategies. Planning follows with the definition of public policies (sectoral and cross-cutting) that will implement those strategies and the assignment of sufficient fiscal (and other) resources to make the policies effective (drawing up of multi-annual and annual budgets). After that the budget outturn begins; at this stage it is essential to have the appropriate information to distinguish between cash flows and commitment flows. The budget outturn relates to the two outlooks and they are interconnected when a particular expense or revenue operation is decided upon (a commitment is made) in a given year and only produces cash effects in a future year. Lastly, we have the assessment phase. On the one hand, the contemporary assessment of outturn and, on the other, its *ex post* assessment. The former case calls for the monitoring of commitments undertaken and cash flows evolution in order to understand two things: if the spending ceilings (or income targets, in the case of services whose basic financial function is revenue collection) for the fiscal year in question are at risk and if the political goals served by these budgets are at risk. That monitoring must provide managers and political decision makers with timely information to correct dangerous paths. To that end the control approach that Caliço (2014) defends and, in particular the monitoring indicators he proposes, are part of a contemporary budget assessment system. The *ex post* assessment takes place after the fiscal year-end and falls upon, for instance, compliance with budget targets. At the end of the medium-term period the *ex post* assessment may also fall upon the effectiveness of policies and the reasonableness of the fiscal rules in force in order to inspire the revision of the economic and fiscal strategies for the subsequent medium run.

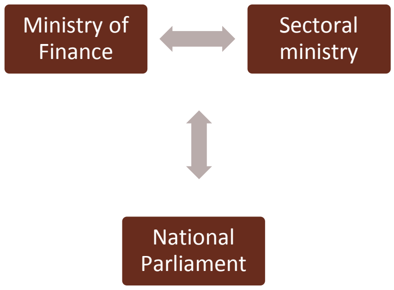
Understanding that outturn is part of a cycle leads to two conclusions. Firstly, it is not sensible to devise rules for the outturn without taking into account the other phases of the budget cycle. The outturn rules, such as the reporting and monitoring duties, should help managers and political decision makers to guide the budget outturn in the planned direction and to aid assessment tasks. Furthermore, the outturn assessment itself must be governed by well-defined rules and be predictable in terms of the reporting duties it places upon the performing entities. Volatility in this field hinders organisations' concentration in the pursuit of their mission. The second lesson to be learnt is that all of the three phases are of a multi-annual duration. The explanation above makes it clear that planning is not exhausted when a budget outturn begins, in the same way that the assessment does not begin only when the former has been completed. There are temporal interdependences between the various phases and they should give rise to self-correction mechanisms for undesirable deviations.

2.2 Strategic behaviour of institutions

There are three types of institution that have important responsibilities within the budgetary cycle of a democratic nation which are worthy of mention: the Ministry of Finance, the sectoral ministries and Parliament. Each country's institutional framework determines the nature of the strategic relationship between these parties. In the Portuguese case (Figure 2), the institutions' incentives appear to be misaligned, which hinders the pursuit of predictable and sustainable public finances.

The Ministry of Finance tends to exercise budgetary control in a centralised, discretionary and, often, unpredictable manner. Sound and adventurous budgetary performance among sectoral ministries tend to be treated the same way when the need arises to tighten the aggregate budget constraint. Generally speaking, control over budget outturn is carried out on the basis that a single suit fits all players and no awareness is shown of the idiosyncratic circumstances of sectoral policies and the entities that implement the budgets on behalf of those policies. The difficulties faced when attempting to apply the commitment law in the local subsector and in hospitals show the limitations of this attitude. The repeated exercise of this type of control by the Ministry of Finance ends up influencing the behaviour of departments and those responsible for sectoral policies, leading to phenomena of free riding and adverse selection, and eroding financially more responsible conducts.

Figure 2 — The institutional triangle



It is also important to recognise that, generally speaking, the sectoral ministries do not perceive sustainability of public finance as their problem. Too often, concealment and inefficient budget outturn are the optimal response, from the individual standpoint, in order to retain and increase budget appropriations. The asymmetry of information on the availability of own revenue, which persists despite the progress made in terms of applying the treasury single account principle, is a boost to this "cat and mouse" game.

The National Parliament is a cornerstone of this strategic game. It has a committee that specialises in budgetary affairs and committees specialising in sectoral affairs. The two types of committee oversee the State Budget. However, they do it in a schizophrenic manner, regardless of the parties that in any one parliamentary term support or oppose the government in office. During the period set aside for discussing the State Budget for the following year, the Minister of Finance may be hammered by the Opposition in the Budget and Finance Committee because they think public expenditure is excessive while at the same time the sectoral committees hammer the sectoral ministers for not exhausting the appropriations at their disposal or accuse them of not having political clout within the Government when, from one year to the next, they lose a greater share of general revenue than their colleagues. In fact, Caliço (2014) is absolutely right when he states that Parliament does not pay proper political heed to the sectors' intra-annual budget outturn.

Given the nature of the strategic game between the three political players in the Central Government budget, we must conclude that the incentives are not aligned so that cooperation will be the outcome of balance — the classic outcome of the prisoners' dilemma, in fact. Therefore, this is a challenge the country must overcome: to change the rules of the game so that all agents feel that cooperation for the sake of budget predictability and sustainability is the type of behaviour that best serves the naturally different interests of each agent. We will return to this matter in Section 4.

2.3 Flaws in strategic consistency

Strategy is an essential attitude in the budgetary cycle: at all stages. The country needs to have an economic strategy, a fiscal strategy and strategies for sectoral policies. Those strategies are devised or updated in the planning phase, put into practice in the outturn phase and assesses both over their useful lives and at the end of their respective terms.[2] The strategies give rise to policies and their instruments and these are very often expressed in the budget outturn.

Although it is not an exclusively Portuguese attribute, reality has shown that the country does not get along with strategy in public policies. It is not for a lack of inherent capacity to think strategically; the major difficulties are in the ability to integrate strategies and to act over time in a manner consistent with them. In the field of public finance Portugal repeatedly demonstrates the following strategic consistency flaws:

- no integration of economic and fiscal strategies;
- no linkage between sectoral policy strategies and fiscal policy strategy;
- disregard for strategy following its approval.

Public revenues and expenses do not occur in a vacuum; they only exist to the extent that economic activity exists. Furthermore, businesses and households naturally behave differently according to the type of State Budget. The way in which and the level to which public revenues are generated affect taxpayers' choices, be it between consumption and savings, between work and leisure, or between more or less investment and in which sectors, without mentioning the more microeconomic effects. It is also important to stress that the State Budget or, more generally, public finance is not an end in itself but rather a means, no matter how important it is, for society to become happier, *i.e.*, for the economy to generate more well-being, distribute it differently or minimise fluctuations in it.[3] Therefore, it makes no sense to devise a strategy for public finance without, at the same time, devising a hinged strategy for the economy; the two must be articulated. It is necessary to identify the main obstacles to growth, to equity and to the stabilisation of well-being, be they in the corporate or household sphere or within the State itself and in the public finance situation. The solutions to public finance problems have to be thought out in line with the responses that the State may (and may not) give to overcome those obstacles. The sustainability of public expenditure is one of a number of questions that are greatly contingent upon the existence of this linkage. Furthermore when building economic strategy and fiscal strategy it is essential to involve properly those who will be affected by the policy measures, both to get what they know about the problems and possible solutions, and to mobilise them in order to implement the strategies. Hence the importance that must be given to social dialogue.

Now Portugal's experience since the birth of the euro through the formulating of fiscal strategies (stability programmes and, since 2011, the so-called fiscal strategy documents — FSD) shows how far away practice has been from those principles. Governments come and go but the conviction remains that fiscal strategy is the sole responsibility of the Ministry of Finance and economic strategy, when it exists, is a concern of the Ministry of the Economy. And every seven years there appears an economic development strategy designed primarily to frame the use of European cohesion policy, rural development and maritime affairs funds which, for its part, does little to articulate with fiscal strategy; typically compatibility studies on national public contribution rates, the macroeconomic scenario, budget targets and levels of public investment laid down in the FSD are unheard of — see CFP (2014, pp. iii-iv) on the inadequate link between the 2014/2018 FSD and the

[2] In many cases it is appropriate to undertake an *ex ante* assessment of the strategy.

[3] Readers more familiar with public economics will recognise here the three famous economic functions of public finance immortalised by Musgrave (1959): allocation, redistribution and stabilisation.

2014/2020 Partnership Agreement. One gets the idea that the strategies are planned in isolation, without taking into account their reciprocal implications.

The second type of strategic inconsistency is between sectoral policies and fiscal policy. Once again it is common for them to be built separately and this should not occur, especially in the case of policies that have significant impact on the aggregate budget constraint, be it via their impact on competitiveness and the level of business in the short run, or be it via the impact on public expenditure. Fiscal strategy planning does not usually involve analysis of the expected effects of important economic policy measures that the Government has underway or plans to implement within the period covered by that strategy and this weakens the actual fiscal policy that is pursued.[4]

Lastly, mention must be made of a third defective practice from the strategic standpoint. That is the extreme levity with which the strategy tends to be abandoned before being evaluated and, worse still, shortly after it has been approved and began to be implemented. In the case of fiscal strategy, a stability programme or a FSD often follows on from a previous one having revised the guidelines, the spending ceilings or other numerical targets without any deep rooted justification, without any explanation why a five-year plan needs to be radically revised every year, and that is if it is not revised several times a year through successive laws. In this way fiscal policy becomes accommodating and unpredictable, losing its ability to support and guide economic agents' expectations. Under these circumstances, it would be better to accept that there is no strategy and that a discretionary approach is preferable to multi-annual rules.

3 Public finance management: paradigm shift

I believe that the framework described above makes the position I took in the introduction clearer. There I held that control in itself is not sufficient to minimise the deficit bias in budget outturns and, consequently, to ensure the predictability and sustainability of public finance. I think that insisting on what has been the dominant approach until now, in particular that the goals require greater power to be given to the Finance Minister and greater centralisation of sectoral budget management is counterproductive. On the contrary, what Portugal needs is public finance management. This means a different paradigm to deal with deficit risk. A paradigm that calls for a systematic rethinking of all aspects of the budgetary procedure. In this section I merely suggest some areas to be explored.

3.1 Integration of medium-term economic and fiscal strategies

The reasons underlying this integration have been sufficiently discussed in the previous section. It is up to the politicians to define the length of the medium-term. There are arguments in favour of four years so as to coincide with the parliamentary term or to coincide with two halves of consecutive terms. There are also arguments in favour of a seven-year period, so that it coincides with the length of the European Union (EU) budget cycle, given the strong strategic and fiscal link

[4] For example, on 23 April 2013 the *Strategy for Growth, Employment and Industrial Boost 2013-2020* (Government of Portugal, 2013a) was published followed one week later by *FSD 2013/2017* — Government of Portugal (2013b). As the CFP (2013, p. 10) notes, "it would be useful to find in the document a first analytical attempt at combining fiscal consolidation measures with growth inducing measures in the medium run".

between European policies and national policies, bearing in mind that within the EU major policies and their budgets tend to be revised in depth every seven years.

3.2 Regular assessment and review of public policies

In the mental framework that I have suggested, public policies must be of a strategic nature and be maintained long enough to produce the desired results and be assessed periodically. Undoubtedly changes in the policy framework, such as technology, preferences, education, ideology, mobility, purchasing power and the external balance are in themselves good reason to strategically review policies. It is clear that an assessment, especially an *ex post* one, may be very useful in identifying these and other causes of any ineffectiveness of the tools used or, even, of the inadequacy of the policies' goals. Furthermore within a democracy it is legitimate for governments to use the assessment information to review the tools "engineering" and priorities between policies, thereby increasing or decreasing the intensity of financial resources *vis-à-vis* other means.

Once this general principle of public policy governance is accepted, it is sensible and viable for the Government to undertake an examination of the budgetary impact of the public policies it intends to implement. The English speaking literature calls these examinations "public spending reviews". Examining the contribution of each area of government to public spending and revenue would make a valuable input to the formulating of medium-run fiscal strategy. Note that the aim is not to reduce or increase spending (revenue) parametrically, but rather to reflect upon the quality of the public policies that impact on the budget and to accept the consequences in terms of funding allocations to them and to the general government as a whole. These reviews seek answers to two basic questions: should this policy be funded by public money? What is the benefit to society of the expense incurred by that policy? It seems to me that answering these questions is the smart way to avoid blind cuts or increments in public spending. For an analysis of the factors critical to success in the construction of this approach see, for example, Vandierendonck (2014).

Incidentally, if Portugal is to proceed in this direction it will require a rethink of the availability of financial information on public policies. The economic classifier employed by the State Budget will not get us there. Budget classifiers are required in all areas of government that will permit a distinction to be made between an entity's expenditure and a public policy expenditure. That is a feasible option as the existing budgetary information on Social Security instruments proves. The coexistence of two sorts of accounting classifiers is both possible and desirable: an economic classifier to monitor the sectoral and aggregate budget outturn, which is of particular interest to the Ministry of Finance (and to the independent fiscal entities concerned) and sectoral classifiers for monitoring the budget outturn of policies that are of particular interest to the sectors. The recording of a particular operation in the accounting system should allow for simultaneous recording in the economic classifier and the respective policy classifier. In addition to the harmonious coexistence of these classifiers, a structural improvement in the quality of the accounting information itself is required (more on this in Subsections 3.5 and 3.6).

3.3 Fiscal discipline rules

For a long time the economic literature has stated the advantages and also recognised the limitations of rules that tie, in a credible manner, the government's fiscal performance to a three to five year period (medium-term). Portugal and the EU have made progress in this respect over the last three years. The first application of the set of new economic governance rules[5] to medium-term national budget plans took place in the first half of this year in Member-States that are not subject to financial assistance programmes. Clearly more experience and more evidence are required to consolidate this framework. Indications so far are that some problems have arisen which must be dealt with over the next two years:

- statistical controversies associated with the measurement of potential output and the estimation of fiscal elasticities;
- the relatively ambiguous classification of temporary measures and one-off measures;
- intelligibility of legal texts, in particular on the structural deficit and significant deviations from its numerical target;
- lack of transparency towards the independent fiscal institutions and the public in general in regard to the agreements on methodology reached by the Economic Policy Committee working parties that impact on the monitoring of budget rules compliance.

3.4 Multi-annual anchors for public expenditure

Caliço (2014) supports the adoption of a medium-term fiscal reference frame and provides some of its component parts. Indeed its adoption is essential and I would like to suggest a few features for the expenditure limits. The existence of spending ceilings for each year of the medium-term horizon brings important advantages.

First of all, a ceiling for overall general government expenditure boosts confidence in the sustainability of public finance. This occurs whenever such ceilings in the medium-run framework commit annual budgets to the public debt sustainability track underpinning that reference frame. Secondly, a ceiling on the total expenditure of each policy or each ministry, consistent with the aforesaid overall ceiling, encourages the provision of details on the medium-term view for the sectoral public policies. At the beginning of each parliamentary term the Government selects its priorities for allocating financial resources to the sectors. The respective multi-annual ceilings reduce uncertainty within ministries, which encourages multi-annual policy programming. This framework means sectors can focus on the outcomes of policies by removing the inherent pressure of having to deal with the annual and intra-annual uncertainty about the available appropriations. It should be apparent that this item is consistent with the vision of the fiscal cycle mentioned in Subsection 2.1. Lastly, the existence of ceilings for each department encourages efficiency gains in the management of those departments. Greater predictability as to the funds available up to the end of the current year and in the four following years will make public managers more motivated to … manage. It becomes easier to search for better price-quality ratios in supply contracts, reduce risks and develop synergies. Today the legal and administrative complexity of large volume procurement procedures increasingly clashes with the strict annual basis of the fiscal appropriations. With greater flexibility with respect to the annual basis and even the quarterly limits that the commitments law lays down, managers will have more scope and can be made more accountable for incurring expenses when they are more needed or effective, instead of having to buy wholesale or in a rush at the end of the year.

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[5] *Six-pack, Treaty on Stability, Coordination and Governance and two-pack*. A brief explanation is given in European Commission (2013).

While it is clear that each type of ceiling, *per se*, brings its own advantages, it would be wise to recognise that this approach has its frailties. These stem from the risks to which a government budget is inevitably subject. In effect, the more numerous and fragmented (by decision level) the ceilings are, the greater the system's rigidity and its inability to deal with the hits. Furthermore, the wider the range of spending covered by the ceilings the greater the difficulty in meeting them in an emergency caused by a major hit. On the other hand, a multi-annual reference framework that is not credible, that has to be revised continually, is worthless. For this reason, in practice it is necessary to take a pragmatic stance and devise a multi-annual setting with a degree of tolerance. To pursue this topic further would divert this article from its goal and its scale, so it will come to an end here by recommending further reading on the subject, also inspired by comparative international analysis: Harris *et al.* (2013). After analysing 24 experiments in the same number of advanced economies, the authors propose a guide to customising a medium-term fiscal planning.

3.5 Accrual accounting in general government

We have already called attention (end of Subsection 3.2) to information quality. Now we wish to stress again this essential aspect of public finance management, this time as regards the significant inadequacies that general government still reveals in relation to accrual accounting and, consequently, to the combined workings of accrual accounting and budget accounting.

For the reasons already stated, both department managers and the Minister of Finance and the sectoral ministers have a great deal to gain from the existence of a genuine accounting system that incorporates all accrual and budget transactions, in line with their economic classification and the sectoral policy classification. The advantages of this integration include the eradication of distorted views of reality that the exclusive use of one type of indicator (accrual or budgetary) can cause. Ignorance of the current implications of decisions taken in the past or the future impact of today's decisions can prove costly to the taxpayer. The limitations that accrual accounting still brings to general government, in particular within the central government, are sources of error that society could happily live without. Involuntary or deliberate they generate information asymmetry and feed the non-cooperative strategic game between the sectors and the Ministry of Finance described in Subsection 2.2.

Ideally the budget position monitoring tools of each department or each policy should be automatically generated outputs of the accounting systems. The entities responsible for this monitoring, beginning with the sectoral ministries' assessment and inspection departments, would then have access in real time (or almost) to the outturn of the variables that they should be checking. Since central government does not have an accounting system that incorporates commitments and cash flows and consolidates data from departments in real time, monitoring budget outturn (budgetary control, if you prefer) requires the case-by-case reporting of the spending departments, which diverts scarce human and IT resources to the monthly production of dozens of independent accounting tables, with the inherent errors and waste. Even if the automatic provision by the accounting systems of all the items needed to monitor budget outturn is not the ideal solution, it is certainly economically advantageous to replace most of the current hand-produced reports by remote consultation of data cubes without disturbing the work of the spending departments' staff. This possibility will be examined further in Subsection 5.1.

3.6 Treasury single account principle

One complementary aspect of the above is the recording of financial operations. The treasury single account is a good principle but it urgently needs to be enhanced. There are still considerable lags in the recording of transactions between public services that complicate the real time intra-annual calculation of the government's cash position. We also need to understand why many departments have difficulty in depositing own revenues in *the Agência de Gestão da Tesouraria e da Dívida Pública* (IGCP) account. Once again these situations generate asymmetric information and conflicts between the sectoral ministries and the Ministry of Finance which end up harming all concerned.

3.7 Identifying and managing of fiscal risks

A fiscal risk exists whenever a budget variable deviates from the track established in the respective planning document, in the short- or medium-term. The risk is the greater, the higher the probability of the event occurring and the greater the numerical impact of the deviation. While the severity of the risk depends upon the magnitude and the importance (political, financial) paid to the variable in question. Thus, risk cannot be disassociated from uncertainty, or from human beings' inability to predict the future without making mistakes. That having been said, it should be added that it is possible and desirable for the public sector to develop an institutional architecture capable of minimising the risks and managing them, in other words, a system that allows the country to live with fiscal risks without major dramas.

Risks may be classified by their source as general economic risks, specific risks and structural and institutional risks — Budina and Petrie (2013). The former arise from forecasting errors in the macroeconomic scenario adopted to set the track of a particular budget variable. The cause is relatively removed from the typical dynamics of that variable. While specific risks arise from surprises in the actual framework of the variable in question. An epidemic may lead to an unexpected rise in health spending to the extent it is largely determined by demand. Other examples are the need for budget support to a public corporation or a private bank or the calling on of a guarantee granted by the State. In Portugal the risks associated with contingent liabilities and relatively opaque liabilities, such as guarantees and levels of demand in PPP contracts, may have a devastating effect on budget predictability, if ignored. Lastly, structural risks and institutional risks. The former are associated with the economy's structural features. For example, when an economy is very dependent upon oil production, public revenues tend to be unstable because they depend greatly upon the price of crude which is also unstable. Institutional risks are related to the frailty of the institutions connected to the budgetary process.[6]

The reports that accompany the State Budget draft and the Fiscal Strategy Document have shown improvement in terms of the attention paid to fiscal risks. However, it is possible and desirable to do more. The thorough revision of the budgetary process that Portugal requires must have implications for the fiscal risk management system, a matter that should involve the Ministry of

[6] *Institutions* in the broad sense of Cangiano *et al.* (2013) recalled on page 3 above.

Finance and the sectoral ministries. The Budina and Petrie (2013) article draws lessons from international experience in this matter and discusses various techniques for identifying, mitigating and managing those risks, and constitutes a source of inspired reading for Portuguese reform.

4 Comments on Orlando Caliço's proposals

Having presented the backdrop against which I think it makes sense to equate the continuing difficulty of complying with general government budgets, I would like to comment, cautiously, upon the proposals for changing the control system put forward in Caliço (2014). For the sake of argument, the proposals may be grouped into two categories: macro rules and micro rules. The former are the principles and rules that Orlando Caliço presented for the framework that is upstream of the budget outturn; the micro rules are the public services' additional reporting duties during the outturn. I will comment on each category separately.

4.1 Decentralisation with accountability: right incentives

The proposals under discussion put forward a series of changes to the framework upstream of the budget outturn for a particular year and are, in my opinion, very welcome and in keeping with the public finance management model outlined in the previous sections. Let us recall some of them: sectoral ministers' accountability for the budget outturn of their respective ministries to the Minister of Finance and the Prime Minister, as well as to the National Parliament; the Minister of Finance's accountability for macroeconomic management and management of the aggregate public budget constraint; an end to appropriation freezing and to the providing of funds to departments in twelve instalments; permanent vigilance on the part of managers and accountable politicians in relation to fiscal risks; online publishing of budget summary and prospects for each department, as well as of performance indicators.

To have the desired effect, some of those changes call for supplementary measures. For example, an end to releasing funds in twelve instalments will require an alternative mechanism. One possibility would be to replace this mechanical rule applying to all departments (the twelve parts rule) with a cash flow plan to be agreed between each spending department and the Treasury, realistically adjusted to the former's cash needs. This requires integrating accrual accounting and budget accounting, articulating accounting with the single account at the Treasury and providing for real time checking of accounting operations and banking transactions by the department and the appropriate monitoring entity within the Ministry of Finance. Naturally the development of these requirements was beyond the limited scope of budgetary control proposed by the Fridays of Reform organising committee but it is important not to lose sight of the holistic view of these matters to which this comment subscribes wholeheartedly.

Either way, the framework proposed by Caliço (2014), which can be summarised as "**decentralisation with accountability**", delivers the appropriate incentives to the three categories of players who will determine whether the change is a success: the Minister of Finance, the sectoral ministers and the public service managers. The proposed arrangement encourages the following desirable types of behaviour, bearing in mind the **predictability and sustainability of public finance**, the **effectiveness of public policies** and the **efficiency of general government**:

- Minister of Finance — focused on public finance sustainability and the stabilisation and redistribution functions of the public budget; guardian of fiscal strategy and co-guardian of economic strategy; respecter of sectoral budget appropriations (half way towards making sectoral budget constraints hard);
- Sectoral ministers — free from "moral hazard"[7] relating to the overall budget constraints (reduces conflicts in the management of common-pool resources)[8]; focused on the effectiveness of the respective public policies;
- Managers — free from "moral hazard" in regard to others' appropriations; focused on the effectiveness of the public policies they apply; focused on the efficient and effective management of the departments they run.

4.2 Additional reporting duties: are they really necessary?

Caliço (2014, p. 24) also proposes a series of new reporting duties for any public entity that is deemed to be "an important unit or one whose budget outturn is deemed to be a risk". That department would be obliged to declare monthly a matrix with the "actual and expected amounts until the end of the year and the following two years" in regard to the following variables: revenue and expenditure on a cash basis (large aggregates); debts to suppliers; debts to financial institutions; financial investments; number of staff.

According to the management model proposed in the previous sections, overloading the departments with new reporting duties does not appear to me to be the best course to reach the goals. Rather it would be better to focus on improving the accounting system and real time checking of the state of each department's accounts by the bodies responsible for monitoring and overseeing the budget outturn. All data required to perform these tasks should be taken directly from the departments' accounts instead of being provided through reporting instruments. The latter method is a source of errors and consumes resources without adding value. It is necessary to recognise the degree of exaggeration that has been reached with the demands for reports from the departments to Ministry of Finance bodies. Even units with less than 10 staff have to complete and submit to the Ministry of Finance the modicum number of … 187 reports per year! There are 26 different instruments, 13 of which are completed monthly, six quarterly and seven annually. They are set out in the Appendix. It is worth remembering that:

- there are around 400 departments that are subject to these reporting duties;
- most data reported exists in the accounting information systems, therefore the respective information could be obtained directly from the systems by the Ministry of Finance units to which they are sent;

[7] Moral hazard means the risk of a party to a transaction not entering into the contract in good faith or not retaining that position. In the financial context, when such a risk exists, the party may adopt attitudes such as the concealment of commitments made to third parties, the inflating of revenues, misrepresentations about its asset or financial position or even its level of debt, among other things.

[8] The management of common-pool resources is studied in several contexts by law, sociology and economics. A possible definition is found in Hess (2006): a common-pool resource is a "natural or human-made resource where one person's use subtracts from another's use and where it is often necessary, but difficult and costly, to exclude other users outside the group from using the resource". In the context of the Portuguese State Budget, the so-called *general revenues* are a good example of a common-pool resource.

- the reports are produced manually, *i.e.*, it is necessary to complete files or fill in electronic forms with data that are originally in the accounting or other information systems used by the departments;
- they repeat information, *i.e.*, there are countless cases (see the right hand column in Table 1 of the Appendix) where the same data have to be reported on separate forms;
- there is a degree of inconsistency between reports (involuntary mistakes and the possibility of deliberate mistakes cannot be excluded).

A glance at the list in the Appendix quickly tells us why people say "the government works for the government itself". In truth, just to comply with these reporting duties requires thousands and thousands of man hours in the departments concerned (depending on their scale and complexity), time that is diverted away from undoubtedly more useful and valuable tasks that government so desperately needs. It can also be argued, in defence of this onus on the departments, that the control, inspection and monitoring entities are being provided with valuable information to which they would not have access any other way and which is carefully examined and processed every day by those entities. However, if this were true, there would clearly be no problems in this field and it would not have been worthwhile holding a seminar on budget outturn promoted by *Fridays of Reform*. In fact it is not difficult to anticipate the answer to the following questions: do the entities that receive the reports have the human and technological capacity to i) check the consistency of the information received? ii) use that information to justify Ministry of Finance management decisions?

In this context, instead of moving towards additional reporting duties [note that the data that Caliço (2014) requests are probably already reported in some way or other by the departments], it would be preferable to start by making better use of the information already available. This point will be discussed further in the next section.

5 Concluding remarks

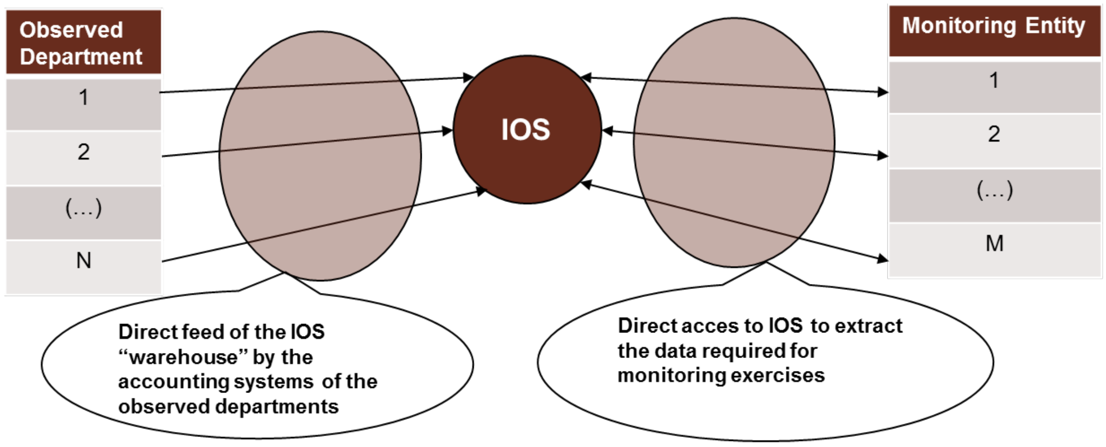
This section concludes the article. It seeks to send out two messages. The first calls for the integration of information on public finance and suggests the creation of a system of shared data similar to that the country devised for information on company business (IES). The second takes up the systemic vision of what Portugal needs in order to have a framework more friendly to public finance and calls for political approval of a roadmap to ensure the gradual introduction of major reform to that framework regardless of which parties are in Government.

5.1 Integrating information

The question of reporting, discussed at the end of Subsection 4.2, as well as the flaws in central government accounting and the link between it and the Treasury single account, discussed in Subsections 3.5 and 3.6, call attention to the crucial role of information in the predictability and sustainability of public finance. The problem in Portugal is not one of a lack of information; it exists and, as it happens, there is an excess of information. The challenge is to ensure the useful information arrives in good time to those who actually need it to take decisions consistent with the predictability and sustainability of public finance. The challenge is to achieve that outcome while minimising the cost of generating, distributing and processing the information.

In Portugal, up to 2007, companies were obliged to submit a number of reports over the year to a series of public entities. Since then, with the introduction of the *Simplified Enterprise Information* system (IES), a single electronic return sent each year is sufficient for those entities to receive the data they need to fulfil their missions. The cost to companies of fulfilling their reporting duties fell extraordinarily, the covered population rose and public entities came to share a technology that is much more productivity friendly. If it was possible to innovate in this manner in regard to a much higher volume of data and reporting bodies than exist in the area of public finance, I would suggest — actually the Public Finance Council has already publically proposed this step[9] — that the country consider creating an **IOS —*Simplified Fiscal Information*** platform. The basic idea is to transform the departments' accounting system into a fundamental source for the work of the entities that monitor the budget outturn.[10] Naturally this requires improved linkage between accrual accounting and budget accounting plus automatic reconciliation of accounting operations and Treasury bank transactions. Figure 3 shows the type of integration we have in mind. On the one hand, the spending departments' information systems and, on the other, the monitoring entities' data processing systems. In the middle, the IOS platform which would be the **common warehouse** for raw data (from the departments) deemed necessary to the work of the monitoring entities. Each entity would only have access to the IOS data required to fulfil its duties.

Figure 3 — Integrated information and the IOS



The integration of these platforms would certainly generate motivation and productivity gains in both the spending departments and the monitoring entities. Human resources in both camps would surely be more committed to the purposes of their respective missions. It would improve the information in the sectoral ministries and in the Ministry of Finance on fiscal risks and the ability to correct them in good time. It would be easier to align Cabinet members' and managers' incentives with the predictability and sustainability of public finance, as well as with the public policy effectiveness and departmental management efficiency.

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[9] It did so for the first time when contributing to revising subnational public finance laws— CFP (2012, p. 23).

[10] In addition to the Ministry of Finance entities referred to in the Appendix, they include the Court of Auditors, the Bank of Portugal, the Inspectorate-General of Finance, the National Parliament Budget Support Technical Unit and the Portuguese Public Finance Council.

5.2 Roadmap to budgetary procedure reform

This article holds the view of public finance management as an integrated reference framework: a system. Since it is not a doctrinaire and wide ranging text on what can and should be done, it merely gives sufficient indication of the multiplicity of matters that need looking at and rationalising in order to produce a budgetary process that is friendlier to citizens, politicians, managers and civil servants and government agents. It is true that many changes have been made to the process since the early 21st century, at least, and at a greater rate during the course of the economic and financial assistance program (2011 to 2014). However, they have basically been parametric adjustments, changes in continuity that do not bring into question the essential nature of a framework that has existed for decades.

It is the nature of that framework that really needs to be replaced and so move from a logic of budget outturn control to a public finance management paradigm. Only then will it be possible to provide the Portuguese with **predictability** and **sustainability** in public finance. Only when these values are guaranteed will the Portuguese be in a position to approve the political alternatives of the parliamentary term without fearing a return to violent adjustment processes. It is not enough for a few dozen specialists and citizens particularly interested in the topic to recognise the need. It must be understood and taken on board by the political powers and by the technical structures within government. It is important to communicate with and involve those subject to the reform with its construction and evaluation. From the institutional standpoint, what is at issue is not only of interest to the Ministry of Finance or to the parliamentary committee on Finance; it is of interest to the government as a whole.

This structural reform will not take place in one go and will require great perseverance in order for all the stages to be completed and the results achieved. As Cangiano *et al.* (2013, pp. 4–5) point out, if innovations are pushed in an isolated manner, the interdependencies they create are not apparent and they will surely fall over each other. That would clearly be the path leading to the frustration of expectations as to an improvement in the state of public finance, to the bureaucratic overloading of general government staff and to **reform fatigue**. For this reason it is highly desirable to map out an innovation plan that can guide decision makers and reform implementers for several years and set off the various stages of change.

It should be highlighted that the institutional foundations, as discussed herein (genuine accounting information, the integration of accounting records and banking operations, mechanisms for monitoring fiscal risks and rules), call for the involvement of many players and several years to consolidate them. For these foundations to be valuable they must be the result of **genuine political commitments**, desired by the parties concerned; they can in no way be surrogates for these commitments. Once the new budgetary process architecture has been put in place, those foundations will favour the implementation of policy by whoever is in Government at any time, since the choices it makes in regards to changes in expenditure and revenue will be based on a predictable and sustainable public finance track. The predictability of fiscal decisions and the sustainability of public debt are highly valuable intangible assets worth procuring. They constitute external factors that cause potential output to grow along with actual income, thereby permanently reducing the political burden and the social drama of fiscal consolidations.

Appendix

Table 1 — List of central government department reports in the field of public finance

REPORT	REPETITIONS AND REMARKS
Monthly report to the portal "Base: Public Contracts online" (public procurement)	
1. Contracts for service provision in any amount: record the monthly outturn of existing contracts and enter new ones	
Monthly reports to Directorate-General for the Budget (DGO)	
2. Commitments made and budget outturn accounts	
3. Multi-annual commitments (record outturn in each month of the various multi-annual contracts)	Part of the information provided in 1.
4. Credit Release Applications	
4.1. Sources and Applications of Funds statements (reporting revenues collected and expenses incurred by economic classification category and identifying the revenue required for the month in question;)	Outturn is already included in the accounting information system
4.2. STF Platform (record revenue to be applied for by economic classification)	Repeats sum calculated in 4.1
4.3. Complete the "Staff compensation related needs" form (show payments made to staff)	Repeats information in 4.1 and in the accounting information system
5. Go to accounting software (GERFIP, in most departments) and make accounting record of revenue received (Credit Release Applications)	Repeats information in 4.2
6. Available funds	
6.1. Aggregate accumulated revenue and expenses outturn	Information that is already included in 4.1 and in the accounting information system
6.2. Payments made	*Idem*
6.3. Revenue and expenditure forecasts for the next three months	Repeats information in 7.
7. Monthly outturn forecast	
7.1. Report on outturn	Repeats information in report 4.1 and in the accounting information system
7.2. Reformulate outturn forecast until December	
7.3. Justify actions if accumulated forecast until December does not coincide with available appropriation	
8. For departments with an investment budget: provide information on expense incurred, forecast expenses, status of NSRF application, etc. on a case by case basis	
9. Overdue payments (by aggregates of items 01, 02 and 07, state outturn and value of payments overdue)	
10. "Budget outturn and budget changes accounts" form. Record by economic classification category and source of funding	
10.1. Accumulated revenue and expenditure outturn up to the specified month	Repeats the accounting information system and reports 4.1, 7.1 and 8
10.2. Budget changes on revenue and expenditure sides	Repeats the data in the accounting information system
11. Loans and other lending operations	Repeats data in the accounting information system. Even entities legally forbidden to contract debt

REPORT	REPETITIONS AND REMARKS
	have to complete this table, with zeros
12. National and foreign trips (when co-financed by a non-resident entity)	Compulsory report even when the information is zeros
13. Monthly analytical trial balance (only departments without GERFIP are required to complete this document)	
Quarterly reports to DGO	
14. Budget outturn report (for departments with no Single Auditor) or Single Auditor Report	
15. Single Account. Record	It was a monthly report until May 2014
15.1. Value of Credit Release Applications lodged	Repeats reports 4.1 and 4.2
15.2. Balance on IGCP account	
15.3. Balance in national banking system	
15.4. Value of payments made	Repeats data already included in reports 4.1, 7.1, 8 and 10.1
15.5. Nature of IGCP balance (if it is a sum carried forward, for example)	
16. Debt and assets positions in terms of debt instruments issued by the general government	Table to be completed even by departments with no debt
17. Financial flows to local authorities	
18. Borrowing operations: record loans and principal repayments, undertaken and forecast	*Idem*
Annual reports (to DGO and, where indicated, to Court of Auditors — TdC)	
19. Management account (submit to DGO and to TdC by 30/04)	
20. Balance Sheet and Income Statement estimates	
21. Record of balance submissions	
22. Plan for reducing overdue payments (only applicable to entities with overdue payments)	
23. Submission of accounts for the year (known as the "13th month", by 30/04; final annual figures by economic classification of revenue and expenditure accounts)	Repeats information in report 19
24. By 15/05, report:	Information that could be extracted from report 19
24.1. Self-financing ratio	
24.2. Budget balance	
Reports to Directorate-General for Administration and Public Employment (DGAEP)	
25. Quarterly report (SIOE): no. of employees by salary band and gender; working timetable by occupation; information on work performed on rest days, holidays and at night; authorised absences by legal regime; amount paid as meal allowances and other employer's expenses; No. of employees with accident-at-work incapacities	Repeats accounting information and various reports to DGO
26. Annual report: social balance sheet (in theory it should match the sum of the same data reported quarterly but the DGAEP is unable to check the consistency of the information)	

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