SUSTAINABLE PUBLIC FINANCES: GLOBAL VIEWS

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SUSTAINABLE PUBLIC FINANCES: GLOBAL VIEWS

Foreword by ICAEW Chief Executive

The world has changed dramatically since the 2008 financial crisis.

From a crisis of confidence in markets, we now face a crisis of confidence in governments. Public trust remains weak as the taxpayer is now the guarantor of whole financial and state institutions. Similar to the coordinated response during the aftermath of the financial crisis, the sovereign debt crisis also requires immediate global action.

The scale of the task at hand is not a one year project. It is one that requires the commitment of successive governments to come. To rebuild public confidence and long-term economic resilience, policy-makers must master the tools for tackling large-scale government deficits.

As a chartered accountant, I recognise that our profession is part of the solution.

ICAEW supports over 138,000 chartered accountants around the world. People with the technical knowledge and skill in accountancy can help governments regain control of public finances. Some of the financial management tools traditionally used in the private sector can support fiscal sustainability in the public sector.

Take the example of the first set of fully consolidated Whole of Government Accounts (WGA) in the UK. Published in November 2011, WGA accounts for 1,500 public sector bodies including central government, devolved administrations, the health service, local government and public corporations. WGA has been developed through accruals-based accounting and international financial reporting standards (IFRSs). It is a tool which found its roots in the private sector and one that already has been used by other countries for fiscal planning – including Canada and New Zealand.

I have commissioned this collection of thought leadership essays to support the awareness of existing policy tools – such as WGA – which aim to support sustainable public finances. This publication also supports ICAEW's wider campaign for transparency, accountability and good governance in the public sector in order to support value for taxpayers' money.

Some of the world's leading experts on fiscal policies from both the public and private sectors are featured in this publication. We are grateful for the valuable contributions which include insights from the International Monetary Fund (IMF), European Central Bank (ECB), Swedish National Debt Office and our partners at the Japanese Institute of Certified Public Accountants.

From my perspective the authors raise four important points for policy-makers to consider:

1 the role of high-quality data in effective policy and fiscal planning;
2 the need for countries to shift from cash based to accruals-based accounting;
3 the importance of financial risk and reporting standards in the public sector; and
4 the fiscal impacts of an ageing population on long-term public finances.

I hope this journal, with its range of global insights and perspectives, will drive evidence based decision-making that restores trust in public finances. There are a number of lessons for policy-makers to consider from the 2008 financial meltdown. One that I aim to explore is how a Government Cabinet would operate with a Chief Financial Officer (CFO) at the decision-making table – a structure that is similar to the private sector.

Michael Izza

Michael D M Izza

WHAT POSSIBLE REASON COULD GOVERNMENTS HAVE FOR NOT INSTITUTING FINANCIAL REFORM?

Ian Ball, Chief Executive Officer, International Federation of Accountants (IFAC)

The sovereign debt crisis has shed a very bright light on the poor quality of financial reporting and financial management by governments.

The financial problems in Greece that triggered the sovereign debt crisis centered on the concealing of deficit and debt positions. These crises have made it clear that accounting for financial performance and position is a job that governments are, in general, performing very badly.

Logically, this should lead to significant reform. We saw how financial reporting failure in the private sector early in this century lead to dramatic action, including the passage of the Sarbanes-Oxley Act, and the creation of regulatory bodies for private sector audits in most major countries.

Given the current state of affairs, now is the time for governments to implement financial reporting reform for the public sector, and take the necessary steps to prevent further crises. Yet, it is astounding that there has been virtually no public acknowledgement that this crisis is a result of poor public sector accounting practices. Many governments still adhere to the cash basis of accounting, which does not provide a comprehensive and transparent picture of their economic situation.

Why has the current crisis not led to calls for action? Aren't good accounting, solid financial management and transparency in the best interest of governments and the public they serve?

There appears to be a lack of political will and drive for sound, transparent reporting on the part of governments. It is critical that governments take steps now to establish greater trust between themselves and their constituents, starting by signaling an intent to produce sensible financial statements. Higher quality, and more consistently applied standards in accounting, auditing, and financial management will address the key cause of the crisis: – the lack of transparent, consistent, and measurable financial reporting.

The need for transparent reporting by governments is long overdue, and independently developed accrual accounting standards are necessary in enhancing government reporting and accountability.

Since 1997, the International Public Sector Accounting Standards Board (IPSASB) has developed a comprehensive set of 31 accrual accounting standards for the public sector, plus a cash-basis standard for countries moving toward full accrual accounting.

The need for accrual-based public sector accounting is recognised by an increasing number of governments around the world, which already prepare financial statements on an accrual basis. More than 50 governments, as well as other public sector entities around the world – of all sizes and at various levels – have adopted accrual accounting standards consistent with IPSASs or have plans to adopt them in the near future. And momentum is building, with the European Parliament directing Eurostat to study the appropriateness of IPSASs for adoption by its member states.

> 'Given the current state of affairs, now is the time for governments to implement financial reporting reform for the public sector.'

Global adoption of IPSASs will facilitate the comparability of information across countries and assist both in the functioning of the market for sovereign debt and in internal resource allocation decisions, monitoring, and accountability.

Governments must act urgently to implement the necessary institutional arrangements to support transparency and accountability in financial reporting. The adoption and implementation of high-quality international financial reporting standards is a crucial step on the road to financial reform.

MANAGING TAXPAYERS' MONEY WISELY

Ken Beeton, Former Director of Financial Management and Reporting, UK HM Treasury (2007–2011)

Accruals-based accounting is vital for all organisations. Any well run business will know the costs of the resources it consumes, and will be able to match them against what it delivers. It will understand the long-term implications of past spending decisions and will not expose itself to the surprises that cash accounting can spring. Governments should be no different.

Public finances represent a large part of national economies. They are funded by taxation and borrowing. If they get out of control and become unsustainable, governments risk losing popularity. Either they must tackle the debts they have created through long periods of consolidation, or ignore them and lose credibility. So sustainable public finances are important. And they generate more certainty and better long-term value.

So how can we use policy tools and frameworks to help us manage long-term stability in public finances? In the UK, we have based our approach on four essential principles: transparency; accountability; simplicity; and coherence. And we have aimed to embed these principles through financial reporting and the scrutiny of accounts.

'Managing long-term stability requires sound financial reporting.'

Managing long-term stability requires sound financial reporting. We need to ensure that the government's financial reports and accounts are comparable and coherent against the wider economy, of which they are part. We have adopted International Financial Reporting Standards (IFRSs) and use an independent advisory panel (the Financial Reporting Advisory Board) to ensure that we maintain a disciplined and consistent approach in financial accounts. We also support and use International Public Sector Accounting Standards (IPSASs).

The next imperative is a 'clear line of sight' in spending departments across the funds voted by Parliament, departmental budgets, and their financial reports and accounts. Effective scrutiny is impossible if these frameworks use different rules and boundaries. So, from 2011–12, the UK has aligned them to improve transparency and accountability. Work is also well underway to understand and eliminate avoidable differences with the National Accounts produced by the Office for National Statistics (ONS). If we can take out unnecessary noise, brigade the differences between IFRSs and the National Accounts into the key structural elements and explain them all in a simple reconciliation, we can further improve scrutiny and decision-making.

Another strand is the UK's first set of Whole of Government Accounts (WGA). These audited statements use accruals-based accounting and were first published for 2009–10. HM Treasury consolidates around 1,500 public sector bodies across central, national and local government, the National Health Service and public corporations. WGA delivers a firm bedrock of financial numbers. It supports long-term fiscal sustainability, removes uncertainty, provides data comparable with private sector financial reporting and reconciles to the National Accounts. This vital component for managing long-term fiscal sustainability had previously been missing and was therefore underplayed in fiscal management.

WGA reflects a measurement at a specific point in time. It cannot capture all the information that decision-makers and other users need. WGA does not show movements arising from the future use of existing revenue raising powers and future service delivery changes. Further financial modelling is needed, and the Office for Budget Responsibility (OBR) now uses all of these ingredients to assess the long-term sustainability of the UK's public finances. Together, these methods provide a coherent set of tools for managing public finances sustainably.

AUDIT IS VITAL TO TRANSPARENT AND ACCOUNTABLE PUBLIC FINANCES

Vítor Caldeira, Portuguese Member of the European Court of Auditors (ECA) since 2000 and President of the ECA since January 2008

At the heart of the enduring financial and economic crisis in the European Union (EU) is a crisis of confidence and trust. Not only have doubts been raised in the financial markets about the creditworthiness of certain Member States but increasingly citizens are questioning the EU's ability to implement its policies and achieve its fundamental objectives.

The focus of EU policy-makers has rightly been on resolving problems of economic governance. However, the European Court of Auditors (ECA) and the Supreme Audit Institutions (SAIs) of the Member States have been quick to warn of the need to take due account of the principles of transparency, accountability, and public audit where public funds are at stake. In particular, SAIs underlined the importance of ensuring sufficient transparency, in the form of reliable and timely information (including national statistics) on the actual or intended use of public funds, and the risks to which they are exposed.

'Public auditors have an important two-fold role to play in encouraging improvements in transparency.'

Public auditors have an important two-fold role to play in encouraging improvements in transparency. First, we must use our audit mandates to report publicly on the quality of existing information and identify deficiencies. And second, we should promote comprehensive financial reporting and audit frameworks that cover the needs of all stakeholders, markets and citizens.

It is clear that a key element in that financial reporting framework should be the adoption by governments of the accrual basis of accounting. Even before the crisis, there was a growing trend towards public sector entities in the EU adopting accrual-based accounting. With the crisis the arguments for making the transition have been further strengthened.

EU governments are now facing increased competition for funding in capital markets, which are used to financial statements produced on the accrual basis. This is particularly true in the eurozone where investors have a choice of government bonds denominated in euros.

The accrual basis of accounting also provides a framework for systematically identifying existing liabilities, and potential and contingent liabilities: the deficiency of current national accounting systems in this respect is a continuing source of uncertainty.

Furthermore, there are working examples of how a successful transition can be achieved. The European Commission successfully adopted accrual-based accounting for the EU budget five years ago. And the UK's Whole of Government Accounts (WGA) initiative provides an example at Member State level.

As the recent exposure drafts and consultation papers of the International Public Sector Accounting Standards Board (IPSASB) acknowledge, the framework for financial reporting may have to extend beyond the preparation of traditional financial statements. It should require governments to report on key aspects of the sustainability of public finances, such as debt and deficits, as well as on whether public funds were used economically, efficiently and effectively and for the purposes intended. If such reporting is to be credible and contribute to restoring trust, it will need to be independently audited in accordance with a comprehensive framework of high quality audit standards, such as the International Standards of Supreme Audit Institutions (ISSAIs).

THE OBR AS A FRAMEWORK FOR STABILITY IN PUBLIC FINANCES

Robert Chote, Chairman of the Office for Budget Responsibility (UK)

The Office for Budget Responsibility (OBR) is one of a new wave of independent fiscal watchdogs created in recent years. Academics had for some time thought that such bodies could help take some of the politics out of tax and spending policy in the same way that independent central banks had taken much of the politics out of monetary policy. The financial crisis, and its consequences for the public finances of many countries, gave the idea an extra push.

The core analytical argument for fiscal watchdogs is that, left to their own devices, democratic governments are prone to 'deficit bias' and 'pro-cyclicality' in their management of the public finances. In other words, on average they borrow more than they should, and in particular they spend too much or tax too little during the good times, when the economy and the public finances appear to be performing well.

> 'The core analytical argument for fiscal watchdogs is that, left to their own devices, democratic governments are prone to 'deficit bias' and 'pro-cyclicality' in their management of the public finances.'

There are many possible reasons for such bias. Ministers may be seduced by their own rhetoric. Governments may be less forward-looking than voters, driven by elections and impatience. Finance ministries may be weaker than the large departments they are meant to control.

You might expect outside scrutiny by unofficial bodies (such as the Institute for Fiscal Studies) to be sufficient to counteract these tendencies. Some countries do not have such bodies, of course, but experience suggests that even when they do governments can all too easily dismiss their scepticism by pointing out that ministers have access to privileged information on the behaviour of tax revenues and public spending that outsiders lack.

The creation of the OBR is designed to breach that line of defence. We have been given a statutory entitlement to all the relevant information available within government necessary to fulfil our core duty – 'to examine and report on the sustainability of the public finances'.

Armed with that entitlement we have been given four main tasks.

- First, we are now responsible for producing the official five-year forecasts for the economy and the public finances that the Chancellor of the Exchequer was previously required by law to produce twice a year. So, rather than simply commenting on government forecasts, the task of producing them has been outsourced to us.
- Second, we use these five-year forecasts to assess whether the government has a better than 50% chance of achieving the two fiscal targets it has set itself. The 'fiscal mandate' requires policy to be set to achieve balance or surplus in the structural current budget five years ahead. And the 'supplementary target' requires the ratio of debt to GDP to be falling in 2015–16.
- Third, we scrutinise and publicly certify the government's estimates of the fiscal cost or saving resulting from particular tax and spending measures announced in the Budget.
- Fourth, we analyse the long-term sustainability of the public finances, looking at 40–50 year projections of tax and spending flows, as well as the health of the public sector balance sheet.

Fiscal forecasting is never easy at the best of times, and these are not the best of times. We cannot promise perfect foresight, but by undertaking and setting out our analysis in as transparent a way as possible we should at least be able to persuade people that official analysis of the public finances now reflects sound professional judgement and the best available evidence, rather than politically motivated wishful thinking.

FISCAL TRANSPARENCY AND SUSTAINABLE PUBLIC FINANCES

Carlo Cottarelli, Director, Fiscal Affairs Department, International Monetary Fund (IMF)

The fiscal accounts of many economies, particularly advanced economies, have deteriorated sharply since 2007 and issues of fiscal sustainability have come once more to the fore. To assess whether public finances are sustainable, governments and the public need high-quality information about the state of those finances – something that the IMF has emphasised since at least the 1990s, when it first published a code of good practices on fiscal transparency.

One crucial source of information is a good set of public accounts. We therefore welcome the UK Government's publication last year of its first set of Whole of Government Accounts (WGA). Carefully prepared and audited financial statements that comply with international accounting standards can contribute to a stronger understanding of public finances and better choices about taxes and public spending.

Good public accounts also make life easier for government statisticians who prepare the national accounts, which underlie fiscal rules and medium-term fiscal objectives in Europe, and elsewhere. National accounts are prepared on an accrual basis that is similar to that underlying modern accounting, so it is simpler if statisticians can make use of accrual-based accounting data. Public accounts can also allow the calculation of alternative indicators of the government's deficit and debt, which can sometimes help reveal fiscal problems not highlighted by headline measures from national accounts.

'Good financial reporting also includes high-quality forecasts of public spending and revenue over the long-term and detailed information on fiscal risks.'

The preparation of government-wide accrual-based accounts is a relatively new phenomenon, having arisen in the 1990s in countries such as Australia, New Zealand, Sweden, and the United States. Not surprisingly, there remain important unanswered questions about what constitutes good financial reporting by governments and how that differs from good reporting by companies. The IMF is therefore following with interest and, where appropriate, contributing to the work being done by the International Public Sector Accounting Standards Board (IPSASB) to develop a conceptual framework for public sector financial reporting.

Good financial reporting also includes high-quality forecasts of public spending and revenue over the long-term and detailed information on fiscal risks. We therefore welcome the IPSASB's publication of draft guidelines for reporting on the long-term sustainability of public finances.

Of course, both public accounts and fiscal statistics have limitations as tools for assessing fiscal sustainability. Any specific set of accounts and fiscal statistics can be subject to manipulations, and bad practices in this area are not infrequent.[1] These limitations, however, should not hinder the efforts to improve public accounts and fiscal statistics. Rather, they imply that relying on a specific and narrow set of statistics may not be adequate. This is another reason why broader, more complete, information on public accounts is needed to fully understand fiscal challenges ahead.

Altogether, it will be critical to ensure that, over the medium term, governments and others have better information about the true nature of fiscal risks than they did before the current crisis. But there is still much work to do to achieve this goal.

Endnotes

1 See Timothy Irwin, 'Accounting Devices and Fiscal Illusions,' IMF Staff Discussion Note, February 2012.

TWO STEPS TO ENSURE LONG-TERM CONFIDENCE AND SUSTAINABILITY IN PUBLIC FINANCES

Fatima Hassan, Public Policy Manager, ICAEW

Four years since the financial crisis, prospects for global growth remain weak and the sovereign debt crisis dominates Europe's economic agenda. Growth and deficit reduction will also define major election battlegrounds in France, Germany, and the United States this year.

Although there has been much agreement on the need to tackle national debt, politically, there has been little attention on how to achieve this in a way that has long-term benefit for the taxpayer, what I would call 'cutting wisely'.

Let's remember – it's not the government's money at risk – it's ours, the taxpayers'.

With this in mind, there are two steps that policy-makers can take to ensure long-term confidence and sustainability in public finances.

STEP ONE: ASSESS YOUR TREASURY'S CASH FLOW

For every organisation (whether public or private) it is important to understand your cash flow. It supports the ability of an organisation to meet its objectives and build resilience against external financial pressures.

For most developed economies, Treasury departments are at the heart of a government's cash flow. While historically Treasury departments levy and collect taxes, in the UK for example, the objective of HM Treasury has evolved to include the control of the country's fiscal policy – such as deficit reduction and cash flow.

When assessing a Treasury's cash flow, there are a set of fundamental questions policy-makers should consider.

- What are a Treasury's financial activities? (eg, to levy taxes, produce a set of government accounts, provide economic analysis).
- How does financial data inform policy? (eg, the role of financial data in decision-making at a Cabinet level).
- How do financial roles within a Treasury interact with each other? (eg, the relationship between the financial reporting directorate and chief economic adviser).
- How do external pressures influence behaviours and outcomes in a Treasury? (eg, the ability of a Treasury adapt to a recession, electoral cycles, or a natural disaster).

The purpose of this assessment is to map out a bigger picture view of your Treasury. It should aim to support policy-makers as they consider how financial activities and external pressures influence the ability of government to deliver public services in the most economical way. It also highlights how the right financial information needs to get to the right people at the right time to enable good financial decisions.

STEP TWO: INVEST IN SKILLS

Financial skills are core to this process. They support the ability of policy-makers to understand and respond to financial information. This assessment needs to be completed by appropriate levels of financial skills and competencies. There is no point having information and knowledge of various pressures without the skills to respond to them.

Beyond political leaders at the top, the day-to-day operation of government is supported by the public sector workforce. So while key strategic decisions are made by an informed few, all civil servants should have an appropriate level of financial skills and capabilities.

'Right financial information needs to get to the right people at the right time to enable good financial decisions.'

As many countries take forward painful deficit reduction plans, it may seem counterintuitive to invest in financial skills. But it is essential for the public sector workforce to be equipped with the skills and capabilities to operate within a limited fiscal regime.

This is not a task that can be undertaken overnight. But one that needs to be adopted in the annual objectives of government departments. Departments need to ensure that colleagues are trained to operate with fewer financial resources. The public sector also needs to develop its managers to lead in a diverse and changing financial environment.

In the private sector, continued professional development (CPD) of staff is required to support career development and the retention of a professional body membership. One example is ICAEW's Financial Talent Executive Network (F-TEN) which is an elite business leadership programme and peer-to-peer network, developed for senior finance professionals to drive succession planning, career development and ultimately, business growth and performance.

Together these two steps (an assessment of a Treasury's cash flow and investment in skills) can support long-term confidence and sustainability in public finances.

THE IMPORTANCE OF SUSTAINABLE PUBLIC FINANCES

Dr. Wolf Klinz is a Member of the European Parliament since 2004 and chaired the European Parliamentary Special Committee on the Financial, Economic and Social Crisis (CRIS) from 2009 to 2011.

The current sovereign debt crisis is mainly a crisis of confidence. It requires both further integration in the European Union (EU) and a strong fiscal union to restore confidence in the euro. Reinstating trust by investors as well as citizens is needed in order to safeguard the system. The combined market and state failure questions even the very adequateness and sustainability of our European social market economy. Sustainability of public finance plays a key role in this regard.

Five elements are necessary in order to re-establish confidence in the ability of policy-makers and our social free market economy at large.

1 Transparency and long-term planning is a necessity.
2 Soundness of statistical data by improving the quality of data is necessary to ensure comparability and adequateness.
3 Implicit liabilities have to be included in government budgets.
4 Household consolidation needs to remain an over-arching policy goal.
5 Sustainability in the long run is the only means to success.

At the core of confidence is trust and dependability, which is established through high levels of transparency. Reliable financial statistics on public finances are indispensable to the assessment of a country's debt and stability. This will enable both the public and policy-makers to act responsibly, but the basis for this is sound data and statistics. The past has shown that sovereignty of national Member States in statistical matters has led to poor quality data and in exceptional cases even the falsification of such data. Statistical data needs to follow the principles of independence, reliability, timeliness and transparency.

The ability to assess the sustainability of pensions systems and the relating fiscal policy choices are essential to establish more transparency. Therefore, it is indispensable that governments move to accruals-based accounting to match outstanding future liabilities (such as pensions) with the necessary assets and savings. The recent adoption of the framework for strengthened economic governance in the EU is a step in the right direction. It forces Member States to use actuarial recording of public pension liabilities for the medium-term budgetary objectives and surveillance of the stability programmes. This provides a structure for including outstanding/implicit liabilities relating especially to ageing and a changing demographic in debt and deficit targets.

Responsible financial planning requires that contingent liabilities are identified and preparatory work undertaken to match future requirements. The assessment of public debt (eg, in the form of credit ratings) should reflect implicit liabilities and potential future funding mismatches. Putting the house in order requires a long-term perspective, particularly as the real challenges still lie ahead. A study from *Stiftung Marktwirtschaft*[1] shows that implicit contingent liabilities, including the costs of an ageing population, represent possibly 27% to 1,000% of GDP in the EURO12-States. This means – for most Member States – that further consolidation is inevitable due to the financing gap growing bigger in the years to come.

'Confidence in the common currency and the capability of governments will largely depend upon sound public finances.'

Confidence in the common currency and the capability of governments will largely depend upon sound public finances. The measures discussed above are a necessary prerequisite to assessing and achieving this goal. To return to trust, sustainability should be the major goal of European Member States, now more than ever.

Endnotes

1 Moog, Stefan and Raffelhüschen, Bernd, 'Ehrbare Staaten? Tatsächliche Staatsverschuldung in Europa im Vergleich', Argumente zu Marktwirtschaft und Politik, Nr. 115, Dezember 2011, Stiftung Marktwirtschaft, ISSN: 1612 - 7072

SUSTAINABLE PUBLIC FINANCES – LESSONS FROM SWEDEN

Bo Lundgren, Director General, Swedish National Debt Office. Between 1991 and 1994, Mr Lundgren was Minister for Fiscal and Financial Affairs.

Countries with public finances out of order are, as we have experienced time and time again, very vulnerable. Unfortunately it is often difficult to identify underlying fiscal problems, for example, when they are hidden by unsustainable booms in the economy. Twenty years ago Sweden was financially hit like so many other countries are today.

The seventies and eighties were, in important ways, lost decades for Sweden. They were characterised by policies that harmed growth and encouraged inflation. However on the surface things seemed to improve in the latter part of the period. Growth increased and deficits disappeared. The then Minister of Finance was even declared world champion of economics by a Swedish business magazine in 1987.

But the improvement of the public finances was a reflection of overconsumption and overinvestment in the private sector after deregulation of credit markets in 1985. Done in an environment with high inflation it led to a huge real estate bubble that burst in 1990.

The consequences were a systemic banking crisis and a collapse of domestic demand as Swedish households started consolidating their balance sheets. The private savings ratio shifted from a negative 8% in 1990 to a positive 12% in 1993. Tax revenue decreased and public expenditure rose with lower consumption and higher unemployment. Added to that were cost for managing the banking crisis and higher debt servicing cost.

'It is important to design austerity measures with limited negative effects on growth.'

The best way of handling a financial crisis is of course to avoid it by sound macroeconomic policies. But it might be difficult to pursue the right policies if problems are hidden. Increased transparency is hence desirable. There is a need for improved accounting standards for public finances.

When it comes to dealing with the acute crisis there are no shortcuts. Expenditure has to be cut and revenue increased. But there are two ways that both have to be considered. You can make discretionary decisions to change tax and expenditure legislation and you can improve conditions for growth.

It is also vital to identify the causes of the fiscal problem. If one is a rebalancing of private sector balance sheets it is necessary to understand that you have to be cautious with austerity measures. The experience of the thirties horrifies. The major part of the public consolidation should come when the private adjustment is made. On the other hand you need credibility so the best is to take early decisions on measures that are implemented gradually considering the macroeconomic impact. One Swedish example is abolishing housing subsidies amounting to 2% of GDP. This decision was taken in 1992 and it was phased in over five to six years.

It is important to design austerity measures with limited negative effects on growth. On the contrary the design should be improving conditions for potential growth. Tax revenue should be increased by broadening tax bases instead of raising rates.

In order to avoid future crises there should be an overhaul of the budget process in government and in Parliament. The new Swedish budget law which has strong support strengthens the power of even minority governments as the opposition has to unite on the whole budget in order to overthrow the budget proposal. Parliament now decides on an expenditure ceiling proposed by the government. If broken, government has to propose measures to come back under it. Better monitoring of public finances was also an important part of the budget reform.

Sweden managed its crisis and learnt the lessons. We now have stable public finances and a debt that has declined from 78% of GDP in 1995 to around 30% this year.

WHY DO SUSTAINABLE PUBLIC FINANCES MATTER? A CENTRAL BANK PERSPECTIVE

Philipp Rother, Head of Fiscal Policies Division, Directorate General Economics, European Central Bank

'Central banks are often accused of being obsessed with inflation. This is untrue. If they are obsessed with anything, it is with fiscal policy' (Mervyn King, 1995). If Mervyn King's somewhat provocative observation contained some wisdom in the 1990s, this wisdom has been brought to the fore with almost brutal force over the past two years.

As we have been painfully reminded by recent events, unsustainable public finances, bringing with them the spectre of a sovereign default, jeopardise the functioning of the economy. With the threat of a government default, large parts of banks' asset portfolios lose value, putting the stability of the entire financial system at risk. And in today's global economy, both direct financial exposures and more indirect confidence effects mean that such shocks are easily and immediately transmitted on a global scale.

But even well short of such dramatic events, unsound public finances are liable to inflict damage on the economy. As the need for the government to finance its rising debt absorbs available funds and enterprises fear future economic disruptions, private investment tends to suffer. In addition, governments will be constrained to support the macroeconomy or the financial sector should this become necessary so that the risks of deeper crises increase. And if the public expects the real debt load to be reduced by inflation, then inflation expectations are liable to become unanchored. This then requires the central bank to keep policy interest rates higher than would otherwise be necessary, again to the detriment of financing conditions in the economy.

While crucial for economic stability, the sustainability of public finances is not easy to assess in practice. Unlike corporations, states are assumed to live on indefinitely. Dissolving the state and disposing of its assets to cover outstanding liabilities is generally not an option to deal with sovereign obligations. As a consequence, the economic concept of public finance sustainability is derived from assessing a government's income stream and obligations into the indefinite future. If the government's infinite discounted income stream covers its obligations, the government fulfills the so-called 'present value budget constraint' and is solvent in the economic sense.

In practical terms, this concept may be of limited value. For investors it is crucial to know if a government will be able to roll over its outstanding debt in the foreseeable future. But this depends on other investors' willingness to continue to provide financing. There is, therefore, a risk of self-fulfilling prophecies: once some investors start to doubt that other investors will provide funding for a government and consequently reduce their own supply of funds, this can very quickly trigger precisely the event – a government default – that these same investors had feared.

What does this imply for fiscal policy today? It needs to be recognised that the risks arising from today's already very high levels of explicit government debt are aggravated by the existence of considerable, additional implicit and contingent liabilities. First, there are the contingent fiscal liabilities stemming from the possible need to devote further funds either to international rescue packages or to prop up the domestic financial sector. Second, there are the implicit liabilities related to population ageing and – also related to this – uncertainty regarding the outlook for economic growth over the longer term. For these reasons it has been suggested – and indeed seems logical – that so-called 'debt tolerance' (ie, the level of debt that market participants view as safe for an individual country) has fallen for some industrial economies to levels previously considered more relevant for emerging markets.

> 'With the threat of a government default, large parts of banks' asset portfolios lose value.'

What can governments do about this in the short run? The obvious answer is to build confidence by developing and communicating credible fiscal consolidation plans, based on prudent economic forecasts and well-defined structural measures. In this regard, governments must not hide from the fact that the scale of today's problems in many cases will require sizeable adjustments to be maintained over several years. The ongoing strengthening of the EU's rules based fiscal framework will help in this endeavour.

REBUILD TRUST IN GOVERNMENT BY REFORMING FINANCIAL REPORTING

Tadashi Sekikawa, Executive Board Member, Accounting and Auditing Practice for Public Sector, The Japanese Institute of Certified Public Accountants

It has been one year since the devastating earthquake and tsunami in Northern Japan. But reconstruction has not progressed much. For example, in Miyagi prefecture, one of the most devastated areas, the volume of rubble is 19 times greater than the annual disposal of waste from the region. But, the government's efforts to transfer the rubble to other parts of Japan have been met with much resistance by the public due to fear of radiation. People have doubts about the government's position.

As a nation, we lost so much following the earthquake. One of most important losses is the required 'trust' in the government. The Japanese people, as well as foreigners, keep asking whether the government is telling us the truth, when it says 'it is safe', or 'do not worry'.

'We have to rebuild "trust" in the government, both from our own people and foreigners. As for public finance, a transparent and reliable financial reporting system is the first step to rebuilding such trust.'

The lack of trust has also impacted the government's ability to tackle the deficit. Japan's Government Debt to GDP is in excess of 200%. The current Japanese Administration is trying to pass legislation to increase the consumption tax (similar taxation to VAT in European countries) from the current 5% to 10%, to make our public finances sustainable. But it seems difficult to achieve this objective. Such difficulty is attributable, to some extent, to political debates. But a more fundamental factor behind the difficulty is a lack of 'trust' in the government. We only need to look to political history to show us how measures aimed at raising taxes can only be achieved by governments that are trusted.

The Ministry of Finance explains that our public finance record is almost the worst in our history, and the worst among OECD countries, being the reason to raise taxes. While this may be right, the public, whether consciously or unconsciously, feel suspicious of our government. 'Are they hiding something from us?', or 'Are there any hidden reserves or undisclosed assets in the public accounts?' On the other hand, foreign investors may have opposite suspicions. 'Are the Japanese public finances worse than being reported?' 'Does Japan hide its true deficit?'

Fortunately, this huge fiscal deficit has been financed to date by domestic investors that have large savings. But domestic savings will decrease as our population ages. We need to maintain the confidence of foreign investors in the credibility of our public finances.

In the early days of the Fukushima nuclear accident many foreigners left Tokyo, while the Japanese Government maintained that it was not necessary to do so. If, in the future, Japanese public finances become suspect, foreign investors may leave the Japanese market, even if the Japanese Government insists on the sustainability of its public finances.

We have to rebuild 'trust' in the government, both from our own people and foreigners. As for public finance, a transparent and reliable financial reporting system is the first step to rebuilding such trust.

The Japanese Government currently prepares consolidated financial statements on an accrual basis. However, such statements are published only 15 months after the relevant year end and the statements are not independently audited.

The struggle for fiscal sustainability is a battle against time – time of an accelerating ageing society. Fundamental reform of financial reporting is essential to the struggle, and it will take a long time. The reform itself is also a battle against time. It is essential that reliable financial statements, together with other relevant information, be released to the public in a timely manner with an audit opinion by the supreme audit institution. Now is the time to make a decision to start the reform process and to take the first steps in this direction. In this respect, the accounting profession in Japan is ready to support our government.

BANGLADESH ASKS, WASN'T THE CRISIS CAUSED BY THE WEST?

Sumita Shah, Technical Manager, Public Sector, ICAEW

While many countries try to find ways to recover from the biggest financial crisis to hit our global economy, a number of Asian countries have, so far, remained resilient to the effects of this global crisis. However, this is unlikely to continue and there is likely to be a domino effect on developing countries' economies.

Let's take the example of Bangladesh.

Bangladesh has developed in leaps and bounds in the last 40 years, gaining independence from Pakistan in 1971. It is a relatively free society. You could even say that it is more progressive than more established democracies, having appointed two female heads of state! Despite political instability, poor infrastructure, corruption, insufficient power supplies and slow implementation of economic reforms, the Bangladesh economy has grown between 5–6% per year since 1996. Its growth also remained resilient during the 2008–09 global financial crisis and recession.

But, it still has high poverty rates, is overpopulated, and is an inefficiently-governed nation. Inevitably, the global slowdown in leading economies such as US, Europe, and Japan is likely to adversely affect Bangladesh because it relies on these economies for its own stability.

CAN BANGLADESH REMAIN RESILIENT?

Bangladesh needs continued investment to help tackle its high poverty rate, to improve its infrastructure, to tackle employment levels and to utilise its untapped human resource.

Many organisations are calling for improved financial management within governments across Asia and the Pacific. Bangladesh needs funds from donors who want to see effective financial management and monitoring of financial performance of their aid programmes. They want to know that their funds are being spent properly and for the purposes intended. Bangladesh's own citizens and businesses, those paying taxes, want accountability and transparency.

So, what is stopping Bangladesh from moving ahead? The resistance to change is at the political level and stems from a number of things eg, the lack of understanding of financial management principles (Ministers are not, after all, accountants) so their priorities are to manage cash flows for the few years they are in power. Bangladesh's credit to debt ratio is much lower than that of western countries and a simple but perhaps strong argument used is, the West has moved from cash to accruals accounting, yet, both the US and UK failed to manage their risks and caused the crisis to occur – both nations, are effectively, bankrupt! A challenge to the West, perhaps?

There is, of course, more that stops Bangladesh moving forward. It, like many other developing countries, has a history of fraud and corruption that needs to be tackled. Only by putting into place a strong sense of ethics and governance, coupled with better financial reporting, accounting systems and structures, can these issues be dealt with and over time, eradicated. If the government and ministers do not have the will, mind-set or appetite to change, then however hard it tries, Bangladesh will struggle to move forward.

'There is, of course, more that stops Bangladesh moving forward. It, like many other developing countries, has a history of fraud and corruption that needs to be tackled. Only by putting into place a strong sense of ethics and governance, coupled with better financial reporting, accounting systems and structures, can these issues be dealt with and over time, eradicated.'

For Bangladesh, it is both a challenge and an opportunity. The global economic crisis does threaten its economic security and stability. There is, therefore, urgency for it to change and implement sound financial management principals. It is already a leader in democracy; it should now set an example to other developing countries by showing innovation and leadership to tackle this crisis head-on.

ICAEW entered into a twinning project from 2007–2009 with the Institute of Chartered Accountants in Bangladesh (ICAB) to strengthen the accountancy profession in Bangladesh. This was funded by the World Bank. The project focused on developing ICAB as a more effective professional accountancy body, re-launching its qualification and addressing governance and practice assurance issues.

SUSTAINABLE PUBLIC FINANCE AND ORDERLY FINANCIAL MARKETS

Stavros B. Thomadakis, Professor of Financial Economics, University of Athens

The transformation of the financial crisis into a crisis of sovereign debt reminds us that financial discipline is a universal requirement. Inasmuch as globalised financial markets are the locus where private and public issuers compete for capital, stability and orderliness of these markets cannot be achieved without discipline on all sides. Sustainability in public finance cannot be divorced from sustainability in private finance. Rather they must be viewed as parts of a whole.

Economic growth can be threatened by financial growth running out of control and must be safeguarded from financial indiscipline either in the private or the public sectors. If the imposition of financial discipline implies lower but more sustainable growth, we should come to terms with this reality and reorient policies and attitudes accordingly. The behaviour of both financial and political elites must change in the process.

Debt is an extremely useful tool in financial management for private firms and for states. Markets for debt have coexisted for centuries with markets for equity and other securities. Fiscal sustainability does not imply the banishment of public debt. It does imply that the issuance, the service and the disposition of debt remain within the economic capacities of the issuer and that the probability of a break in faith will be (ex ante) very small.

Financing and refinancing of public debt requires responsible policies ie, policies that remain consistent with pre-existing commitments, and allow for new liabilities to be undertaken only if they can be serviced. Democracies experience political cycles that destabilise the balance of commitments and capabilities. However, democracies also thrive on transparency. A consistent accounting framework that illuminates the links of present decisions to future commitments is necessary to anchor and stabilise expectations in democracies. Accrual accounting and a consistent set of accounting and auditing standards for the public sector can offer the transparency needed for the proper functioning of democracies and markets too.

Financing and refinancing of public debt also requires well-functioning markets, markets that are transparent and protected against mispricing due to misinformation, manipulation or collectively held self-fulfilling misperceptions. Fiscal sustainability can be seriously threatened by mispricing in financial markets.

The present state of sovereign debt markets compares unfavorably with that of markets for private securities. The lack of sovereign issuer transparency increases information asymmetries between borrowers and lenders, forces overdependence on rating agencies and creates opportunities for market abuse and mispricing. The lack of transaction transparency in secondary markets for sovereign securities (and related derivatives) maximises the negative consequences of market abuse but also prevents timely recognition of systemic risks.

‘Debt is an extremely useful tool in financial management for private firms and for states.’

There are many intelligent proposals for regulatory reform in financial markets. These are mostly silent about markets for sovereign debt. The global public interest would be well served by reforms in issuer and transaction transparency in these markets. They must be regulated in ways analogous to private securities markets, making proper allowance for the constitutional differences between firms and states.

WHEN DISASTER STRIKES...

Ken Warren, Chief Accounting Advisor, New Zealand Treasury

When disaster strikes, be it a financial or a natural disaster, there is a common approach used by governments. Some governments have a better approach to managing such disasters. Other governments should follow suit.

A financially competent approach concentrates on: the best response and recovery process; the cost of those processes; and how those costs will be paid for. This is how the Australian Government accounted for the 2010/11 southern summer floods and how the New Zealand Government accounted for the recent Canterbury earthquakes. The other approach, the trial-and-error approach to setting up funds, has had its day.

Commonly however, the first thing politicians announce when a disaster strikes is that they have established a large fund to tackle the problem. The main aim of this fund is to reassure the public. But the value of the fund is largely irrelevant. The amounts announced never match up to the final cost.

These announcements are also confusing given the variety of ways the fund can be set up and how they interact with the government's budget process.

Governments can establish a fund as a set of bank accounts within the budget entity. This has no economic impact as it simply increases debt to put money into a bank account. The budget process (the government's real decision-making process) must then kick in at some future stage to allocate money from that bank account, and determine if more or less is required.

Alternatively, governments can establish the fund as an entity outside the budget. This also has no economic impact, but as government pretends it no longer controls the fund, it can put a transfer to the fund in its budget to reflect what it has been saying in the press. There will of course be an off-budget process to manage the sums in the off-budget fund. Either more money will be needed (common), some money returned (uncommon) or the residual used for a different purpose entirely (distressingly common).

Even if a government establishes a fund, it doesn't actually need to fund it! It can simply guarantee other investors put money into the fund. This is popular when cash-based systems are in vogue and cash is tight. It means the current generation of politicians can claim credit for fixing the disaster without fiscal pain, while their successors deal with the fiscal aftermath. In a worst-case scenario, the fund can be met through monetising debt, quantitative easing or printing money.

The whole process is incompetent, ineffective and confusing. It focuses on the pretence of a fund rather than the reality and the effectiveness of the response and recovery.

And we wonder how we got to a sovereign debt crisis!

A competent financial management approach to a disaster provides a rehearsed immediate **response plan** based on scenario planning and previous experience. Politicians are therefore able to say what is happening over the immediate period, what it will cost, and how these costs will respond to the needs of those affected. Beyond this, governments should announce a medium-term process for a **recovery plan**.

This process should include a financial management response team of risk assessors, actuaries, accountants and policy advisers. This team should determine the best response, and the cost of that response. Politicians can then announce when they will be making decisions on that team's recommendations (ideally within a six-week period).

This team should not assess the quality of the government's risk management and mitigation process, such as, or whether the disaster suggests changes are needed to regulatory or other policy settings. Clearly these issues are important, and should be tackled, but they should be outside the financial management of the response to the presenting disaster. If politicians accept the team's recommendations, they can announce the initial cost forecast, and outline how this will be met. These two items should then be incorporated into the budget process for legislative scrutiny. They will be updated through forecasting and accounting processes as the claims development matures.

Many government financial management problems occur from confusing a cost and the funding of that cost as a single transaction. These two ideas are different. The cost of the disaster can be expressed as the cost of services and transfers, that is, the cost of assisting people and institutions to recover from the disaster. The funding of the disaster can be expressed as reprioritisation of other activity, increased borrowing, special taxes or recoveries. These are quite different things. Since the 15th century businesses have recognised this difference through double entry bookkeeping. Now, in the 21st century it is time for governments to catch up.

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Ian Ball has been Chief Executive Officer of the International Federation of Accountants (IFAC) since March 2002. He leads a staff of professionals who support independent standard-setting boards in the areas of auditing and assurance, ethics, accounting education, and public sector financial reporting. Ian previously served as Chairman of IFAC's Public Sector Committee. In this role, from 1995 to 2000, he initiated the development of international standards for public sector financial reporting. From 1987 to 1994, he was with the New Zealand Treasury, first as Director of Financial Management Policy and then as Central Financial Controller.

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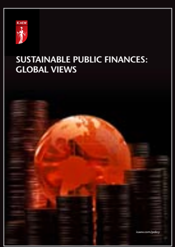

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Edited by Fatima Hassan

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