

## **Changing Roles of Public Financial Management**

James L. Chan, University of Illinois, Chicago, USA

### **INTRODUCTION**

The importance of money to government may be obvious, but good public financial management is often taken for granted. This chapter will discuss how the changing roles of public management alter government's financial management systems. These systems are analysed in terms of their underlying conceptual models. It will be argued that, as government has evolved from a hierarchical bureaucracy to an organization with multiple stakeholders and eventually to a node in an institutional network, the tasks of public managers have been transformed from direct control to balancing the interests of stakeholders (see also Chapter 1). Corresponding to these stages of evolution are the classical model, the NPM (new public management) model and the governance model based on the original insights of Barnard (1968, originally 1938) and Simon (1945). These models are described and compared, along with the key issues faced by practice and research.

Public financial management (PFM) faces several identity issues. First, governments are urged to adopt best practices, but there are few guidelines for assessing PFM quality. Since PFM is a service function, what is its value to clients, and who are these clients? Furthermore, how much resource should be spent on quality improvement? The second issue is whether it is appropriate for government to uncritically emulate private sector practices. Third, what is the proper boundary of PFM? Does 'public' include only core governmental agencies? Or does it encompass government-owned nonprofit institutions and business enterprises? Finally, finance often involves the creative search for financing alternatives; this may be antithetical to prudent and routine management. Therefore, how much weight should be given to the 'finance' and 'management' aspects of PFM? These issues are resolved differently in various PFM systems, which are analysed in terms of three conceptual models below.

#### **LEARNING OBJECTIVES**

- To be aware of changes in governmental financial management systems and to understand their underlying conceptual models
- To understand the context and content of each of the models discussed
- To understand how each of the models is supported by its underlying disciplines

### **THE THREE MODELS**

#### **The classical model**

There are two cardinal rules in the classical PFM model: (1) a government should balance its budget, and (2) a government unit should not overspend its appropriations. These rules are codified in laws and regulations. In the United States, most state and local governments operate under balanced budget laws. Even though the federal constitution does not require a balanced budget, it does stipulate that 'No money shall be drawn from

the Treasury, but in consequence of Appropriations made by Law, and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time' (Constitution of the United States, Article I, Section IX, Clause 7). In conformity with this provision, there are statutes and regulations on budget preparation, approval and execution, and eventual cash disbursement by the Treasury. Financial management makes budgetary resources available to officials to carry out authorized purposes.

PFM is often described in terms of revenue collection and spending. There is, however, no general agreement about the scope of financial management. The revenue side is often slighted, with more attention paid to public expenditure management. Here, budget specialists believe that financial management starts after a government agency receives appropriations — legal authorization to enter into contracts or make cash outlays. As such, financial management is an invisible bureaucratic function uninvolved in policy decision making and largely unaffected by budgeting approaches. As PPBS, ZBB and mission budgeting come and go, financial management ensures organizational stability and continuity by following standard operating procedures (see Box 8.1).

#### **BOX 8.1 BUDGETING APPROACHES**

- *PPBS* (planning, programming budgeting system): favoured in the 1960s to stress longer time horizon and detailed specification of activities.
- *ZBB* (zero base budgeting): a 1970s antidote to incremental budgeting, requiring the justification of every dollar requested.
- *Mission budgeting*: a 1990s reincarnation of PPBS, relating resource requests to goals.

These procedures dictate how transactions are handled. Whereas the budget embodies substantive decisions — who gets what, how much and when — financial management dutifully carries out spending policies. While specific procedures differ from one jurisdiction to another, they generally entail some or all of the following steps: (1) annual appropriations are divided into quarterly allocations; (2) contractual commitments are approved and made; (3) goods and services are received; and (4) payments are made. These transactions are recorded in the budgetary accounting system in terms of the use of appropriations, and in the financial accounting system in terms of effects on assets (economic resources), liabilities (obligations for goods/services received), and revenues and expenditures/expenses (increases and decreases in net resources, respectively).

In addition, there are some specialized functions such as investment management and debt administration. Interested readers are referred to textbooks (e.g. Mikesell, 1995; Coombs and Jenkins, 2001) and manuals for practitioners (e.g. Allen and Tommasi, 2001).

Sound financial management is easier said than done. This is the case anywhere, but especially so in developing countries. The situation is abysmal in the poorest nations:

What is budgeted is often not disbursed, and what is disbursed often does not arrive. Salaries go unpaid for months, operating funds do not materialize, and government debts remain unsettled. At the same time, the executive branch makes unbudgeted expenditures throughout the year. These loose practices make public spending data

extremely spotty — and the data that does exist is often inaccurate or even falsified. (Thomas, 2001, p. 39)

For all its contributions to the smooth functioning of government, the classical PFM model cannot solve two problems: intentional budget deficits and operational inefficiency. Governments can run deficits by deliberately pursuing fiscal policies that cause spending to exceed revenues. They do so in order to achieve macro-economic objectives (e.g. stimulating production and employment) or for political reasons (e.g. placating interest groups). In that case, even the most competent financial management cannot hope to raise enough revenue or reduce sufficient expenditure to compensate for such ‘deficits by design’. Nor can the faithful execution of the law necessarily achieve economy and efficiency. Finance-related laws do not usually deal with performance issues. Furthermore, a mentality of legal compliance is not conducive to creative thinking or actions to lower cost and increase efficiency. The NPM model of financial management arose to deal with these inadequacies of the classical model.

### **The ‘new public management’ (NPM) model**

In the idealized NPM model, the distinction between public management (as distinguished from administration) and business management is blurred to the point that private sector practices are urged upon government. Government bureaucracies turn into strategic business units competing with each other, and citizens become customers. The budget-maximizing bureau chiefs are reformed into cost-conscious and revenue-hungry entrepreneurs. Performance and results — not inputs — are stressed. Government officials follow not the laws of specific jurisdictions but the universal rules of the marketplace: economy and efficiency. A businesslike government naturally uses private sector management techniques.

Accounting-based tools figure prominently in ‘new public financial management’ (NPFM), a term coined by Olson *et al.* (1998). NPFM takes a number of strong normative positions. It insists that accounting principles, set preferably by professional groups independent of government, should be used in budgeting. Double-entry recording should replace the single-entry system. Accrual accounting is offered as an alternative to the cash budget (see Case Example 8.1). The government’s financial picture should be presented as a whole to the public. The full costs of government services should be calculated as a basis for setting prices both for public and internal services. Outputs and outcomes should be measured, compared with benchmarks and verified by value-for-money audits.

Case Example 8.1

**THE USE OF ACCRUAL ACCOUNTING IN THE UK**

In business (including state-owned enterprises), accrual accounting requires recognition of revenue only after delivery of goods and services and expenses - costs of resources used and debts incurred - are matched against the revenue to arrive at a period's income. Applying this method to the core public sector, where taxes are levied to finance collective goods jointly consumed by the public, is highly problematic. Accrual accounting also refers to the recognition and reporting of various rights (assets) and obligations (liabilities).

In the UK since 2000, all financial planning in central government has been done on the basis of accrual accounting (or 'resource accounting', as it is called). Instead of departments having separate cash budgets for 'current' and for 'capital' expenditure, they have a consolidated expenditure limit, calculated by making estimates of the likely current costs and capital costs over the budget period (now typically three years). All assets which are used by the department are charged for, to exert pressure on their economical usage. Departments have much more freedom to decide the balance between capital and current expenditure (but this is still constrained, as capital expenditure usually has to be financed through public-private partnerships, such as the private finance initiative). This system also allows the clear separation of the 'programme budgets' which are used to provide goods and services to customers (e.g. the levels of benefits payments made to claimants), and the 'running costs' which are the managerial costs of administering the programmes.

*Source:* HM Treasury (2000a)

This is the rosy scenario NPFM offers to government. Yet, despite extensive experimentation in half a dozen countries over two decades, a 'globally standardized NPFM system' still does not exist, as there is 'no one way of understanding NPFM' (Olson *et al.*, 1998, p. 437). Although billed as a global movement, the above practices have made the most headway only in the English-speaking developed countries. There the accounting profession, led by chartered accountants or certified public accountants, enjoys a high degree of independence and wields considerable power as arbiter of what constitutes full disclosure to the public. Either directly or in alliance with others, accountants and auditors formulate or heavily influence auditing and accounting principles for corporations, nonprofit organizations and the public sector. These principles encourage (indeed, mandate) transparency of financial matters to the public gaze. Internally, cost-cutting and revenue-enhancement opportunities are identified (see Case Example 8.2).

Case Example 8.2

**TURNING COST CENTRES INTO REVENUE CENTRES**

Osborne and Gaebler, the champions of ‘re-inventing government’, encouraged governments to be entrepreneurial. For example:

- The Milwaukee Metropolitan Sewerage District turned 60,000 tons of sewage sludge into fertilizer every year and sold it for \$7.5 million.
- Phoenix earns \$750,000 a year by selling methane gas from a large wastewater treatment plant to another city for home heating and cooking.
- The St. Louis County Police, after developing a system for officers to telephone in their reports, licensed the software to a private company and earned US\$25,000 for every new user.
- The Washington State ferry system in the early 1980s earned \$1 million new revenue a year through re-tendering its food service contracts; more than US\$150,000 a year by selling advertising spaces in its terminal building; and another US\$150,000 a year by allowing duty-free shops in its two international boats.
- Paulding County, Georgia rented extra beds in its gaol to other jurisdictions for US\$35 a night to handle their overflow, generating US\$1.4 million in fees with US\$200,000 in profit.
- Some Californian police departments reserved motel rooms to serve as weekend gaol cells for convicted drunken drivers at US\$75 a night.

*Source:* Adapted from Osborne and Gaebler (1992, p. 197)

The above stories illustrate the way ‘new public managers’ deal with financial problems. They act like entrepreneurial businessmen, turning cost centres into revenue or profit centres. They master the concept of opportunity costs and eagerly make use of otherwise idle resources. They think ‘outside the box’ by defying conventions and offering creative solutions. Instead of following the rules, they make the rules.

NPFM has the potential to energize an ossified bureaucracy, but there are several problems with it. First, it does not address the core issue in government. In the final analysis, government exists to take care of the consequences of market failure, doing those things for which business lacks incentives or is not equipped to handle. Besides its peripheral agencies and activities (which can be and have been privatized), the government promotes general welfare by providing collective goods and financing them through general taxation. Equity rather than efficiency, economy or even effectiveness is the ultimate criterion in public or political decision making in a democracy. Second, the worst bureaucracies are often pitted against the best-run corporations, thus creating a distorted comparison. As the collapse of Enron (the giant American energy-trading company) and Andersen (one of the former Big Five international auditing/consulting firms) and subsequent corporate scandal shows, all is not well in the business world and the auditing profession. Indeed, the principles of democratic government — separation of powers, checks and balances — might well help to reform corporate governance. Third, in its extreme form, NPFM may be as unsustainable as previous radical reforms. It

elevates administrative discretion at the expense of legislature power. It promotes the ethos of the business-minded accountants against the politically savvy policy analysts. It does not appreciate the primacy and resiliency of budget rules in government. It fails to recognize that cost-cutting could only go so far: below the fat lie the bones — the core government institutions to which the public turns in time of crisis and turmoil. What is needed is a governance model that recognizes the respective roles, competences and advantage of government, civic society and businesses.

### **The Barnard-Simon governance model**

The roots of governance may be traced to an organization theory pioneered by Chester Barnard and Herbert Simon. Instead of profit maximization for stockholders, Barnard (1968 originally 1938) argued that the manager's function was to motivate the contribution of everyone who holds resources needed to carry on the business. Simon (1945) applied Barnard's insight to government in his landmark *Administrative Behavior*. He views an organization — government or business — as being in equilibrium when its managers succeed in balancing the contributions from, and the inducements given to, its stakeholders (see Table 8.1 for examples). Given their knowledge of input—output relationships, managers are keenly aware of the complementarity and substitutability of the resources held by different stakeholders. Their essential task is to maintain a critical mass of the inputs which will be necessary to assure the organization's ability to deliver services. In this regard, what makes financial management crucial is that it controls money — the currency for acquiring a wide variety of other resources. The organizational role of the financial manager is to keep the score of finance-related exchanges, advise management on the terms of those exchanges, and monitor financial performance of all the parties concerned.

Barnard and Simon focused on individual organizations. However, the solution of many complex societal problems requires the co-operation of a network of public and private institutions (see Chapter 13). For example, in the 1999 fiscal year, the federal government in the United States spent only 5.2 per cent of its total expenditures itself in direct provision of goods and services; over 70 per cent was spent through 'indirect government or 'third-party government' (Salamon, 2002). In such a situation, to be effective, government has to empower others, rather than exercising direct control (see Kickert *et al.* (1997) for elaboration). In addition to minding the government's own finances, public financial managers keep a watchful eye on the viability of the institutional network and its participants. Such a role is not unlike that of an organization's financial managers, who monitor its creditors and debtors alike. This similarity has led me to name the governance model of public financial management after Barnard and Simon.

Working through others provides government with more tools (Table 8.2). Besides direct provision of goods and services, government could enter into contracts with, or give grants to, business and nonprofit organizations. It could provide loans, loan guarantees or insurance coverage. Even less directly, it issues regulations to influence others' behaviour.

**Table 8.1** Government as a coalition of stakeholders

Stakeholders	Contributions (benefits to the organization)	Inducements (costs to the organization)
Voters	Legitimacy	Public services to individuals and for general welfare
Taxpayers	Tax dollars	Public services to individuals and for general welfare
Customers	Fees	Specific goods and services for personal use
Grant givers	Financial resources, mandates <sup>1</sup>	Services to target or general population
Bond holders	Financing (for fixed periods)	Interest payments, principal repayment
Vendors	Goods and services	Payments or promises of payments
Employees	Services, skills, ideas	Compensation and benefits (current and future), non-financial benefits
Governing boards, oversight bodies	Authority, police guidance, monitoring of performance	Power, prestige, services to constituency, likelihood of re-election, achievement of personal agenda
Managers	Skills in negotiation, persuasion and implementation	Salary, promotion, career advancement

<sup>1</sup> From higher levels of government, to allow grants to be used in specific ways, and policies as conditions of the grant.

*Source:* Adapted from Chan (1981)

Compared with taxation and spending, these are more complex contractual arrangements. They all have financial implications. Grants, loans, guarantees and insurance are financial transactions. Regulations may seem relatively inexpensive to government (other than administrative costs), but they do impose compliance costs on the regulated. In all these relationships, there exist a set of claims and obligations that bind the government and its network partners. An important function of government financial managers is to help structure contracts with network participants and monitor their contractual performance.

## **COMPARATIVE APPRAISAL OF THE MODELS**

After discussing the models underlying public financial management individually, it is time to bring them together for comparison and appraisal in terms of their context, content and supporting analytical disciplines.

As a service function, the role of financial management is influenced heavily by its

environment. Specifically, the nature of the entity being managed and the higher level manager tend to affect what financial managers do (Table 8.3). In a bureaucracy headed by directors bent on strong control, the financial manager follows rules and carries out orders. The same approach will not work if the financial manager works for a business-minded taskmaster who is constantly looking out for cost-cutting opportunities. Furthermore, a manager in the self-centered mode of NPM has to change his or her mindset when confronted with the need to weave together a network of similarly self-interested institutions. The new environment calls for the ability to see others' perspective, an essential skill in successful negotiations.

**Table 8.2** Tools of government

Tools	Product/activity	Producer or provider	Recipient
Direct provision	Both public and private goods and services	Public agency by government employees	Service recipients, both individuals and organizations
Contracting	Goods and services with attributes of private goods	Contractors (business and nonprofit organizations)	Service recipients, mostly individuals, could be organizations
Grants	Goods and services: public or private goods	Grantee: lower level of government, nonprofit organizations	The public or specific individuals
Direct loans	Credit facility, loan, borrowed money, financing	Public agency approving the loans	Individuals, businesses, other governments, nonprofit organizations
Loan guarantees	Promise to make principal and interest payments in case of default of borrower	Public agency making the promise	Individuals, business, other governments, nonprofit organizations
Insurance	Promise to pay for losses incurred	Public agency	Individuals or businesses
Regulation	Rules and regulations	Public agency	Individuals and organization subject to jurisdiction

*Source:* Adapted from Tables 1-5 of Salamon (2002, p. 21)

Its different roles in altered contexts have serious implications for the content of public financial management (Table 8.4). Financial managers are rewarded for their contributions to conformity (classical model), short-term efficiency and economy (NPM model), and long-term effectiveness and equity (governance model). Consequently, they think of what is managed differently, and monitor different aspects of financial



performance.

Public financial management – in the broad sense – is aided by burgeoning, accounting and auditing (Table 8.5). The input and control orientation in the classical model gives way to the mission-driven output budgets favoured by the NPM model. The macro perspective of the governance model requires a more encompassing (i.e. global) budget to see how resources are allocated to various service providers. Similarly, rule-based budgetary and financial accounting would not be appropriate for the NPM model; what is needed is the ability to analyse costs in support of management decisions. The multiple contractual arrangements in the governance model require keeping track of many claims and obligations. By the same token, the scope of auditing is broadened to encompass non-financial aspects of performance.

**Table 8.3** Context of public financial management

	Classical model	NPM model	Governance model
Entity	A hierarchical bureaucracy in a government with separate powers and checks and balances	A mission-driven and cost-conscious strategic business unit	An organization interacting with others in a network of public, civic and business institutions
Image of the general manager	A budget-maximizing civil servant obsessed with legal compliance and financial control	A public entrepreneur focusing on customer satisfaction, raising revenues and cutting costs	A savvy executive knitting together and maintaining an institutional network to deliver services
Primary role of financial management	Implementing fiscal policies on revenue, expenditure, borrowing and investment	Searching for potential revenues and least-cost method of service delivery	Securing financing in order to keep intact the organizational and network coalitions

**Table 8.4** Contents of public financial management

	Classical model	NPM model	Governance model
Goals and performance criteria	Legal and contractual conformity	Efficiency, economy	Effectiveness and equity
Object of management	Organizational units and sub-units	Services, activities	Multilateral institutional relations
Key financial variables and tools	Revenues, expenditures, investments and debts	Full cost recovery, cost savings and incremental revenues	Revenues, expenditures, grants, contracts, loans, loan guarantees, insurance, regulations

**Table 8.5** Supporting information services

	Classical model	NPM model	Governance model
Budget	Departmental, line-item input budgets	Mission-oriented budgets with output/outcome orientation	Global budgets
Accounting	Budgetary accounting, financial accounting	Product/service costing, differential costs and benefits	Accounting for claims and obligations
Auditing	Compliance and financial audits	Operational audits: economy, efficiency	Audits focusing on outputs, outcomes, effectiveness and equity

## **SUMMARY**

Scholars of public management have over time changed their views of what a good government is. A good government used to be an efficient bureaucracy that faithfully executed public policy. More recently, advocates of ‘new public management’ endow a good government with an entrepreneurial spirit that treats citizens as customers (who care more about outputs and outcomes than inputs). Now a good government plays its part in a larger institutional network. These shifting perspectives have in turn redefined the ideal public administrator/manager. She used to fight to enlarge her agency’s share of the budget pie; now she cuts costs and searches for new revenues, and builds strategic alliances. In service of the new public manager, the financial staff person has to acquire new skills. It is not enough for him to know how to keep the books correctly; he has to spot opportunities for cost savings and revenue enhancements. Better still is a financial wizard who can leverage others’ strengths and defeat competitors. In order to integrate the diverse finance functions, governments have appointed chief financial officers (CFOs) with expanded authority and responsibility. If the rise – and occasional spectacular fall – of corporate CFOs is any guide, public financial management will be anything but dull as governments seek to tackle their fiscal problems with rigour and creativity.

## **QUESTIONS FOR REVIEW AND DISCUSSION**

- What are the salient features of the three models of public financial management and what factors gave rise to their development?
- In what ways can the adoption of the NPM and Barnard-Simon governance models be regarded as changes for the better, as compared to the classical model?

## **READER EXERCISES**

1. Write the job descriptions which you think should apply to the following government officials: chief finance officer, budget director, comptroller, treasurer, internal auditor.

2. Find a copy of the annual report and accounts of your local authority or state government. Try to find within it the following data:
  - the overall level of borrowing of the agency;
  - the overall value of assets of the agency;
  - the proportion of costs of leisure and cultural services which are recovered by fees and charges;
  - the proportion of costs of social care services which are recovered by fees and charges;
  - the level of locally raised taxes as a proportion of total local expenditure.

What do the answers tell you (1) about potential changes in local financial policy, and (2) about the level of transparency in local financial management?

### **CLASS EXERCISES**

1. Should governments in poor countries be exempted from the financial management requirements discussed in this chapter? Which of the models discussed in this chapter is more appropriate for developing countries? Why?
2. A local government health department operates a community mental health centre. The centre's basic occupancy costs (e.g. rents, utilities) are paid by the local government. However, its services are financed by grants. Currently, there are two programmes. The Clinic is financed by a multi-year state grant, and the Community Outreach programme is paid for by a federal grant. Today the centre's executive director received three letters. The health department wants to reduce the centre's budget by 20 per cent. The state is cutting its grant by 30 per cent, and the federal grant programme is being phased out in two years. Advise the executive director what to do and how to go about it.

### **FURTHER READING**

Richard Allen and Daniel Tommasi (eds) (2001), *Managing public expenditures: a reference book for transition countries*. Paris, OECD.

Robert D. Behn (2001), *Rethinking democratic accountability*. Washington, DC: The Brookings Institution.

Hugh Coombs and David Jenkins (2001), *Public sector financial management*. London: Thomson Learning.

John L. Mikesell (1995), *Fiscal administration*. Belmont, CA: Wadsworth.