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FISCAL TRANSPARENCY -- OVERVIEW

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OECD SENIOR BUDGET OFFICIALS' 1999 MEETING

FISCAL TRANSPARENCY - OVERVIEW

Introduction

1. In the aftermath of the financial crises experienced by several countries during the past 18 months, the importance of governments' being open about fiscal and financial policy intentions, fiscal projections and public sector accounts has received considerable attention.

2. This paper:

- describes briefly some of the effects of non-transparency on the behaviour of individuals and markets;
- outlines some of the forces generally seen as motivating transparency and non-transparency;
- proposes a possible role for the OECD in increasing fiscal transparency; and
- summarises a number of fiscal transparency related statements.

How does non-transparency affect behaviour?

3. Non-transparency affects the behaviour of individuals and markets by distorting perceptions about the costs and benefits of government programmes, and by misrepresenting the government's financial position. There are many examples of how this manifests itself in practice: two are outlined below.

- The budgeting and *ex post* reporting practices adopted by a government or agency may consistently under-record the costs of government programmes because only the cash costs are reported, with the consumption of non-cash resources remaining hidden. Where this occurs, citizens are likely to have a systematically skewed view of the benefits that can be delivered for a given level of cost, which will similarly distort expectations about the sustainability of policy settings. This form of fiscal illusion on the part of citizens may strengthen the incentives on political decision-makers to develop government programmes whose full costs can be systematically under-reported - in other words, to keep the veil of non-transparency in place. Citizens' consumption and savings choices will also be affected by their assessment of the sustainability of spending programmes, for any given level of taxation.
- The mis-reporting of the government's aggregate financial position can have a profound impact on the behaviour of financial markets. A frequently-observed example of this practice is the under-reporting, or non-reporting, of contingent forms of government support. The distinction between actual liabilities and contingent obligations can be a fine one; and the mis-reporting of contingent liabilities can result in markets' pricing capital at a lower rate than would otherwise be the case. When previously unreported contingent liabilities crystallise, the implications for the government's financial position can be significant - especially if they are associated with a widespread withdrawal of confidence, as was observed during the recent Asian crisis.

What motivates transparency?

4. Fiscal transparency -- involving systematic and timely public openness in government institutions, fiscal policy intentions, public sector accounts, indicators and forecasts – is fundamental to sound economic and fiscal policy. There are strong arguments to suggest that fiscal transparency supports policy credibility and contributes to macroeconomic stability, allocative efficiency and fairness.

On citizens and markets

5. The two groups with the strongest interest in gaining access to accurate and timely information on the performance and financial position of governments and their agencies are citizens and participants in financial markets. Citizens seek information on the costs and benefits of government programmes, to inform their voting preferences as well as personal consumption and savings choices. Financial market participants seek information on the government's financial position in aggregate, to make rational lending and investment decisions.

On politicians and officials

6. There can be incentives for transparency on politicians and officials. In the case of politicians, we would expect this in cases where politicians perceive that there is a 'political' or personal reputation gain in promoting transparent behaviour. Such a case could occur when a minister for finance feels his or her task is to restrain the spending demands of ministers, but that there is a lack of confidence in either Executive or Parliamentary processes for enforcing that discipline. In such cases, transparency and a formal commitment to ongoing transparency effectively ties politicians' hands removing the choice of using information opportunistically, and making it more difficult to be fiscally irresponsible.

7. Some similar incentives can apply to officials. As the labour market for officials becomes more open and competitive, it is likely that officials will see that a poor organisational reputation may have the potential to impact adversely on the value of their human capital. If transparency increases the chance of better decisions (such as prudent fiscal and financial decisions), then it will be in officials' interests to promote it.

8. These incentives on both politicians and officials will be intensified by any 'psychic' gain from the pursuit of the public good, insofar as they see financial responsibility as being an important ingredient of the public good. Further, some may see transparency in itself as a positive contribution to the public good irrespective of its relationship to decision-making.

9. There can be times when politicians may want disclosure to assist their immediate political goals. But if this desire changes opportunistically through time, then the motivation is clearly not for transparency as such, but seeing certain information at that time as capable of assisting their goals.

What motivates non-transparency?

10. While there are a number of factors that motivate in favour of transparency there are also a number that are sometimes seen as acting in favour of non-transparency. One is that the gains from transparency are spread widely, rather than generally being captured immediately by those being transparent. It means that at the margin, if politicians and officials have discretion on how they wish to involve effort, then they may have choices available that are more beneficial to them and their immediate interests than involving themselves in activities creating transparency.

11. There can also be occasions when non-transparency can be justified – for example, when transparency may undermine the effectiveness of a given policy measure and confer unintended windfall gains on some groups or individuals. Such cases are unlikely to be the usual cases. Indeed, their existence can encourage false argumentation for non-transparency.

On elected politicians

12. Politicians with an interest in seeking re-election may have an incentive to control the timing and nature of published information on the financial position of the government. There are two reasons for this: first, by controlling the flow of information, politicians can influence towards the more positive the public's evaluation of 'their' programmes. Secondly, maintaining secrecy over official information creates opportunities for special interest groups to exercise a disproportionate degree of "voice" over policy development. These two factors, individually or combined, may support the politician's electoral interests. Conversely, greater transparency increases the political risks associated with implementing policies that are unsustainable.

13. Further, at different times, politicians may be involved in policy debates and negotiations of various sorts where gaming of information may assist their position. For instance, one case may be when the fiscal position picks up more than expected while political consideration is being given to a wage round negotiation. There are many other cases when the flow of information can assist in the development of an argument or an agenda.

On officials

14. Civil servants, like employees generally, have an interest in maintaining (or improving) their position and standing. One way of doing this may be to control the availability of information that might be useful for an assessment of performance. This can create a form of barrier to entry - denying access to individuals or groups with an interest in monitoring the performance of administration, as well as minimising the scope for contestability in the (re-)appointment of civil servants.

15. Officials and politicians may also share an incentive to avoid perceptions that policies have been unsuccessful. Again, one way of doing this is to control the flow of publicly available information on the effectiveness of government programmes.

What mechanisms exist to increase transparency?

16. There are countervailing incentives facing politicians, civil servants and citizens/markets, which will influence the degree of transparency of government operations.

17. Generally, the evidence suggests that the proprietors of information are usually best placed to control the form and content of its disclosure, and that quite often the incentives for non-transparency overpower the incentives in favour of transparency. This suggests that in the absence of some form of supra-jurisdictional intervention, the degree of transparency will be less than most desirable.

18. The recent illustrations of the transparency problem in the Asian economies have given greater emphasis to the various initiatives being undertaken by international organisations aimed at improving governance practices and enhancing transparency. These include:

- the IMF's Code of Good Practices on Fiscal Transparency, and the associated draft Manual;
- the Programme for Accountability and Transparency (PACT) sponsored by the Management and Development Governance Division of the UNDP; and
- the World Bank Economic Development Institute's Governance and Anti-corruption Programme.

19. The IMF Code and Manual are specifically concerned with fiscal transparency. The Code is based around the following four interlocking principles:

1. Clarity of roles and responsibilities - which emphasises the importance of establishing clear boundaries between the public and private sectors; and within the public sector between fiscal, monetary and government business enterprise activities.
2. Public availability of information -- which addresses the need for governments to make a commitment to publish financial information at clearly specified intervals, and for that information to be comprehensive.
3. Open budget preparation, execution and reporting -- which is concerned with statistical and accounting standards for government reporting.
4. Independent assurances of integrity -- which stresses the need to provide assurance through external audit and statistical independence.

20. Whilst the IMF Code (and its associated Manual, self-evaluation report and questionnaire) have the potential to enhance significantly the observed standard of fiscal transparency, they nonetheless rely on voluntary adoption by governments, coupled with self-assessment of the degree of compliance.

21. The IMF's draft Manual on Fiscal transparency proposes a set of requirements for a minimum standard of fiscal transparency. It is acknowledged that some countries already follow a number of these principles and practices, although the majority of countries will need to invest significant effort to implement the Code in full. To date, three countries have published self-evaluation reports under the Code -- the United Kingdom, New Zealand and Australia*.* These countries have invested in recent years in a number of high profiles efforts to increase overall transparency, and in many ways are unlikely to be representative. This is borne out by the responses to the SBO questionnaire on fiscal transparency.

A possible role for the OECD?

22. The OECD – through Working Parties, such as the Senior Budget Officials, or more formally via its Council -- provides machinery for Member countries to commit to certain practices or actions.

23. An opportunity exists for the OECD to take on a peer leadership role, and through this, speed-up the world-wide shift to better fiscal transparency. In general, OECD member countries tend to adopt budgeting and reporting practices that are towards the more sophisticated end of the spectrum, and accordingly they are well-placed to demonstrate an enhanced commitment to fiscal transparency. Placing a heavier burden of proof on Member countries would in turn reinforce the commitment of OECD Members to combat corruption, and the G7's objective of strengthening the international financial architecture.

24. One way for the OECD to do this would be to develop an enhanced set of best practice recommendations that build on and extend the IMF recommendations, recognising the degree of sophistication of member countries' budgeting and reporting practices.

25. Specific examples of how this could build on the existing code and current practice might involve recommendations concerning the following:

- Pre-budget
- The budget, its timing and its economic assumptions
- Ex post financial reports, including within year reporting, mid year updates and the annual financial statements
- Pre-election reports
- Long term financial projections
- The nature of and responsibility for determination of government accounting standards.

26. Appendix One lists the characteristics of some major transparency related reports, which could be considered a starting point for the determination of best practices in fiscal transparency.

This report was prepared in consultation with Simon Bradbury, the Senior Project Manager of the International Federation of Accountants' Public Sector Committee Accounting Standards Project. The views expressed here do not necessarily reflect the views of the International Federation of Accountants or its Public Sector Committee.

APPENDIX ONE:

SOME BEST PRACTICES IN FISCAL TRANSPARENCY PRACTICES

The following practices are drawn from the country survey. They include major statements or practices that encourage transparency.

1. Pre-budget statements

What: A report outlining *aggregate* levels of revenue, expenditure, surplus or deficit, and debt. Can be expressed as percentages of GDP (for example, a maximum deficit of 3% of GDP) and in nominal terms, and cover the upcoming fiscal year and the following three years.

When: Several months prior to the release of the government's budget proposal.

Why: The objective is to cast budget policy in a more macroeconomic and medium-term setting, thereby establishing a top-down fiscal policy "anchor," i.e. a pre-determined limit on total levels of expenditure. Focuses debate on the appropriate size of the public sector, the sustainability of the settings and the economic impact of aggregate revenue, expenditure and debt movements. Such statements can help get buy-in for difficult budgetary decisions and lock-in to the aggregates, so that expenditure proposals are considered within the context of a hard budget constraint. In several countries, the government presents these plans to the legislature but it varies whether the legislature formally approves them or not. Each annual budget should show how that budget relates to the fiscal objectives set in these statements.

2. The budget and its economic assumptions

What: The budget is the primary document for seeking parliamentary approval for expenditures. The budget should encompass all planned government expenditures.

A transparent budget requires explicit detail of the economic assumptions used. Sensitivity analysis can show the impact of a change in the economic assumptions on budgeted outturn. A clear comparison can be made between the economic assumptions used in the budget to those used by non-government forecasters. Where credibility of government forecasts is especially low, it may be useful to establish a panel of independent economic forecasters to recommend the economic assumptions to be used in budget preparation.

In recent years, many countries have also adopted 'fiscal rules'. In such cases, transparency requires reconciliation of the budget position to those rules.

A transparent budget should also include:

- Forecast financial statements -- these should parallel the year-end accounts to be presented. These should occur at whole of government level and at other levels reflecting the accountability regime in place for the subsidiary units of government.
- Forecast performance statements -- these should show what is expected to be achieved through the use of public money. Such statements should reflect the accountability regime in place for the subsidiary units of government.
- A medium term framework -- this should provide a mutli-year spending and revenue framework, making it clear how the upcoming year relates to the out years.

- A statement of fiscal risks -- this should detail the known risks to the fiscal position. Where possible, the listing of specific risks should include an estimation of the monetary value of the risk and some assessment of the probability of its occurring. This can be a logical place to include the discussion of the fiscal exposure to changing economic events and cover contingent liabilities estimates, commitments that are difficult to measure and other events which may have a material effect on the budget but which are difficult to assess.
- A statement of tax expenditures -- an estimate of the costs to the tax base of the preferential tax treatment provided to some activities. The basis for measurement should be made very clear, as the starting point tax base is not generally clear. This informs consideration of the government's budgetary choices.
- A statement of any quasi-fiscal activities -- this should make transparent the nature of any such activities being undertaken outside of the budget sector. Where possible, and material, the fiscal significance should be estimated.

When: Approval prior to the start of the fiscal year.

Why: If approved prior to the start of the year, the budget acts as the authority for the whole year. Such budgets can obviate the need for 'supply' periods and, in some cases, gives greater credibility to the allocations provided. Transparent assumption practices reduce the likelihood of derailment due to reliance on unreasonable forecasts.

3. Tracking and update reports

Monthly outturn reports

What: Reports showing the progress in implementing the budget as planned on pre-established dates. They should contain a comparison between the actual outturn and the planned outturn or forecast track. The outturn -- both planned and actual -- should be disaggregated by major functional categories and economic categories. A brief commentary should accompany the numerical data. For example, if a divergence between planned and actual occurs, it is very useful to have a commentary on why this happened.

When: Monthly. Promptly, within five weeks of the end of the period being covered.

Why: Informs markets and others of the progress in hitting the budget. Assists in no surprises.

Mid-year updates

What: A comprehensive update on the economy and the fiscal position. This should include an update on economic forecasts, taking into account new information since the budget, and the implications of the update for the budgetary position. It provides an opportunity to update formally the expected budgetary outturn and budgetary track for the remainder of the year.

When: Midyear.

Why: A pre-commitment to updating the budget track reinforces the orderly management of the fiscal position, and lessens the chances of surprises.

4. Annual financial statements

What: Annual financial statements -- or the government accounts -- are a major compliance report for parliamentary and wider accountability and are certified by the auditor. The annual financial statements are a special case of the monitoring reports referred to above. The main differences are that the annual statements are audited, and contain more detail than would be expected in the midyear or monthly updates.

Some aspects of the design and coverage of financials statements will be determined by the accounting and budgetary standards and policies used (see below). An important condition is that these statements should re-present the main budgetary statements, which are by their nature *ex ante*, on an *ex post* basis.

High transparency financial statements should include statements of the following --

- Budgetary outturn -- as above; this should be supported with information on how variations to the budgetary outturn are sourced, including, where applicable, unappropriated or contingency funded expenditures.
- Debt structure and borrowings - the structure and characteristics of debt held by the government. These statements should include the following: duration, form of interest (variable versus fixed), currency of denomination and counterparty risk.
- Commitments -- this covers political and operational commitments, which are not 'captured' in the current year budget, but will need to be in subsequent years.
- Contingent liabilities - these are liabilities that will materialise *only if a certain event occurs.* Examples include government guarantees and indemnities, uncalled capital, legal proceedings and disputes, and - most recently in OECD Member countries - environmental clean-ups.
- Trust moneys held by the government -- these are funds for which the state has a stewardship responsibility but generally no direct financial interest in the balances held. In some case the state finances the difference between the trust fund balances and the policy commitment.
- Accounting policies – all financial statements should spell out the basis upon which they are compiled so that readers can judge their significance.

When: Annually, within four months of the end of the period.

Why: The annual financial statements provide a key link back to the budget and for other accountability purposes.

5. Pre-election reports

What: Special pre-election fiscal and economic reports. These reports are essentially similar in content to the mid-year updates, and make clear the economic and fiscal situation prior to elections. To have credibility, they need to be produced via a process that is supported by major political interests. This may involve a designated politician (the finance or prime minister) certifying that she has communicated all government policy decisions that have a fiscal dimension to a designated senior civil servant or expert. Then the senior civil servant certifies that the finance ministry, or some other agency charged with that responsibility, has used its best professional judgement in estimating the fiscal position based on available information on government policy decisions.

When: Four weeks prior to elections

Why: These statements assist the quality of pre-election debate. They also act to limit the chances of governments' spending-up prior to elections and/or bolting-down after elections.

6. Long term projections

What: A statement of the forecast track for major budgetary aggregates over the long term. Should include as a minimum the social security or pension system, but can be supported by more comprehensive estimates of expected revenues and expenditures over a long period, say, forty years. Due to the high level of uncertainty in such outlooks, it can be useful to augment the base case with high and low scenarios.

When: Annually or whenever changes are proposed to the system of social security.

Why: Even under accrual reporting, there are many future receipts and payments that are not recognised. For instance, social security pension liabilities are not recognised – principally because they do not meet the reliability in measurement criteria associated with accounting requirements. However, because of the ageing of the population, social security payments constitute a major source of pressure leading to change in the structure of financing government. The financial calls placed on government by these schemes are a major influence on the degree of sustainability of any budgetary settings. If budgetary settings are not sustainable, then at some time, there needs to be a policy shift. Providing forward looking information, such as this, allows individuals to foresee such shifts and plan accordingly and informs public debate.

7. Accounting standards

What: Regardless of what accounting standards and policies the government uses, these should be clearly stated in the financial statements. Accrual accounting provides for the more timely recognition of economic events and disclosure of stocks as well as flows, thereby informing interested parties of the economic significance of a greater array of events.

Why: Accounting treatments rely on the application of accounting standards and policies. The quality of these standards and policies will influence the quality of the financial statements. The credibility of the financial statements can be influenced by the degree to which such standards and policies are determined by persons who do not have a direct interest in the numerical value shown in the financial statements. Externally determined accounting standards can be expected to have greater credibility than internally generated standards. However, in many cases, actual treatments rely on finer judgements than are prescribed in standards. In all cases, the standards and policies applied should be transparent.

The accounts associated with the accrual method of accounting (the operating statement, balance sheet and cash flow statement) provide a more comprehensive basis upon which to assess financial performance than cash statements only. Accruals mean that revenues and expenditures are recognised when the transaction or event takes places, not when the actual cash changes hands. Secondly, accruals require that a balance sheet be constructed - with assets on one side and liabilities and equity on the other - (annual depreciation showing up as an expense in the government's income statement). Recording the value of assets should encourage better management of them.