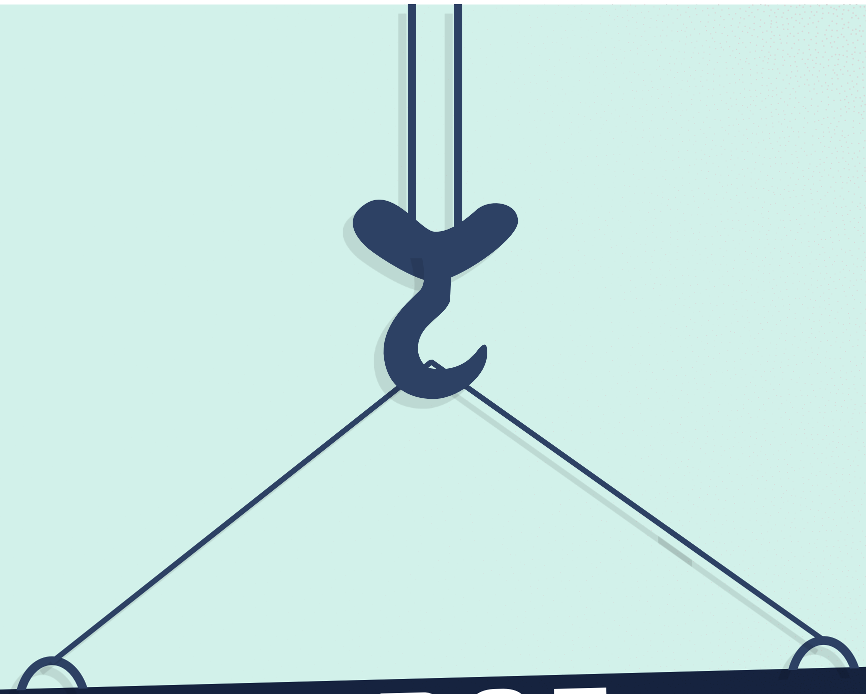
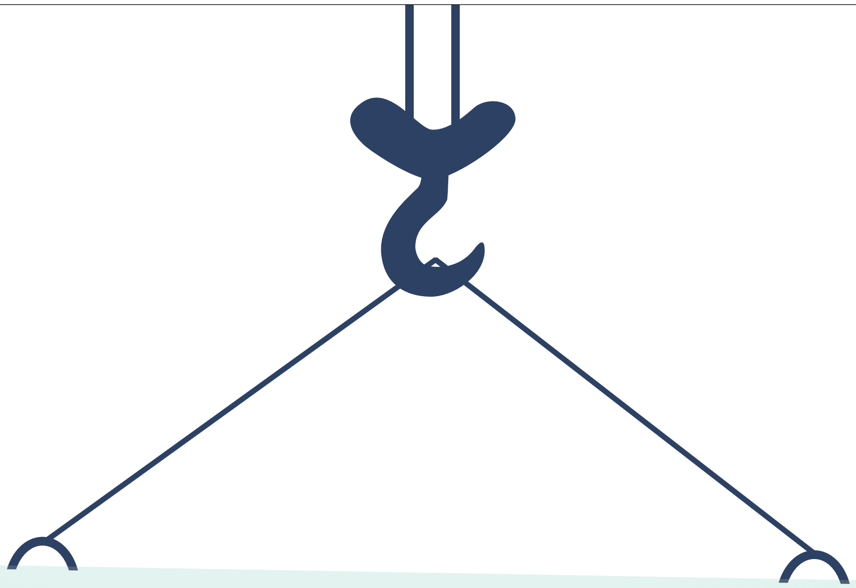


FIRST PRINCIPLES OF PUBLIC FINANCE

BY SHAYNE KAVANAGH AND CHRISTOPHER PIKE



The first principles of public finance are the indispensable complement to best practices and foundation for innovation

A "first principle" is a basic, foundational concept. First principles represent the most essential elements of any given pursuit. Just as accounting has first principles, such as reliability, timeliness and consistency; public finance has its own first principles.

We can illustrate with a first principle from our personal finances: "spend within your means." It is a fundamental truth that spending more than your income allows will get you into dire straits.

"Best practices" are a desirable way to achieve the first principle. For personal finances, paying off debts is part of spending within your means. One best practice is paying off the highest interest debt first, known as the debt avalanche method. Another is paying off smaller debts first, known as the debt snowball method.

The debt avalanche method is more cost-effective, but the debt snowball method provides faster successes,* thereby providing encouragement to the debtor. Someone who needs encouragement may be better off with the snowball method, while someone who doesn't need it should use the avalanche method. So, which is truly "best" will depend on the debtor. Yet, the first principle of spending within your means remains consistent.

Before we get to the first principles of public finance, let's say a little more about why it's important to understand first principles and not just best practices. We can take inspiration from a Japanese concept called *"shu-ha-ri."* Shu-ha-ri represents three levels of learning.

The first stage, **"shu,"** is following best practices without concern for the underlying reasons. Here, best practices are central.

For a field to advance, practitioners must deviate from the current best practice to discover the next best practice. The second stage, **"ha,"** involves understanding the underlying principles and learning from others. For example, governments can adapt new ideas from private firms. However, private firms don't have the same concerns about the democratic rights of citizens, so private practices need to be adapted in a way that respects the public nature of government.

The final stage, **"ri,"** is where the practitioner can create their own practices best suited to the circumstances they face. Another word for this is "innovation." First principles guide innovation. In government, first principles ground innovation in the public purpose of government and clarify the purposes that innovation must serve.

A less flashy cousin of innovation is adaptation. Differences in organizational capacity, elected officials' interest, and other factors affect whether a best practice will work. Keeping the first principles in mind helps finance officers find the best way to serve their community by adapting practices to the situation.

Let's now dive into our first principles of public finance.

RETHINKING BUDGETING

The public finance profession has an opportunity to update local government budgeting practices to take advantage of new ways of thinking, new technologies, and to better meet the changing needs of communities. **Rethinking Budgeting** will raise new ideas and will produce guidance for state and local policy makers on how local government budget systems can be adapted to today's needs. Learn more: **gfoa.org/rethinking-budgeting**

* Where success is defined as a debt being paid off.

FIRST PRINCIPLES OF PUBLIC FINANCE

Here are the first six principles of public finance. As far as we know, this marks the initial effort to identify the first principles of public finance. Thus, our list may not be exhaustive or perfect. We sought out review from all GFOA members over the summer of 2024 and expect that this list can be refined. We invite you to refine it for your own purposes and share your feedback with us. For each first principle, we will present:

- **The first principle** itself.
- **The fundamental truth** about public finance that the first principle comes from.
- **Examples of how the principle relates to practice.** Each example will show how the principle relates to existing GFOA best practices (gfoa.org/best-practices) and to emerging concerns that are being addressed by GFOA research.

As we will see, our proposed first principles of public finance are often rooted in the basic rights of citizens under a democratic government. These principles would only change if there were a change in the constitutional order. Further, the first principles apply equally to all types of local governments.

We will also see that some of the first principles are in tension with one another. We feel this tension is healthy and accounts for some of the "messiness" or "excitement" (depending on your perspective) of public finance work. The final section addresses that tension.

#1 PROMOTE ACCOUNTABILITY

First Principle: Ensure accessible, understandable, timely, and accurate reporting of financial information to the public and oversight bodies.

Fundamental Truth: Stakeholders have a right to understand how public funds are being managed and used. Accountability supports trust in government operations.

Application: The most obvious application is public sector accounting. It is not coincidence that "accounting" and "accountability" share the same root word and root concept of being held to account for financial information and actions. GFOA has a best practice titled "Meeting and Exceeding Minimum GAAP Financial Reporting Requirements" that advises practitioners to prepare financial statements in accordance with Generally Accepted Accounting Principles (GAAP), maintain an adequate accounting system, issue timely financial statements, and have said financial statements independently audited. As a result, many local governments produce an annual comprehensive financial report (ACFR).

An ACFR provides a great deal of information. Much of that information is not understandable to non-experts or may take so long to produce that its impact on decision making is lessened. Therefore, it is a GFOA best practice to establish processes to regularly compare budgets to actual results throughout the year.

Most people aren't "numbers people" and struggle to analyze data. However, they still have a right to know about their local government's finances. For that reason, GFOA has explored ways to improve fiscal fluency for stakeholders. This includes recognizing bold new approaches to communicating financial information and challenging members to innovate ways to help non-experts better comprehend financial concepts.

#2 CREATE VALUE WITH PUBLIC MONEY

First Principle: Implement processes and systems that optimize the allocation and use of resources to achieve outcomes that advance the government's mission and are aligned with the public's interest in the short and long term.

Fundamental Truth: Public resources are limited and should be used in an effective and efficient manner to maximize the value the public gets from government spending.

Application: This first principle recognizes that local governments are not created for a financial purpose. They exist for a public purpose. Thus, public finances must connect money with the good it does. Many of GFOA's budgeting and capital planning best practices speak to creating value with public money. For example, performance measures provide insight into how well money is being used. Strategic planning and multi-year capital planning align resources with the government's strategic goals, priorities and community needs.

Incrementalism is a classic problem in public finance. It involves relying on historical spending patterns and making minor adjustments each year. This can lead to a disconnect between government spending and the community's current needs and ability to pay taxes. GFOA's Rethinking Budgeting initiative was launched, in part, to help public finance balance between questioning and changing past spending patterns with the cost and effort required to do so.

#3 ENSURE FAIRNESS

First Principle: Develop decision making processes that are perceived as fair, demonstrate respect, and ensure people feel heard. Promote financial policies and resource allocations that respond to the needs, contributions, and circumstances of individuals and communities.

Fundamental Truth: Fairness is elemental to trust in government. Without it, a government can't be at its best. Public finance is often about who pays and who gets what, where questions of fairness are critical.

Application: GFOA best practices have long addressed basic issues of fairness. For example, governments should contribute the full amount of their actuarially determined contribution (ADC) each year for defined benefit pensions and other post-employment benefits. This prevents future generations from paying the cost of public services that were rendered in the past. Similarly, debt management policies should prohibit issuing debt with a payback period longer than the useful life of the asset being financed. This prevents future generations from paying for assets or services that they can no longer use. Finally, it is a long-standing best practice to provide the public with opportunities to influence decisions that affect them.

As U.S. society becomes more prone to conflict, practices that ensure fairness must rise to the occasion. GFOA's series on fairness in public finance (gfoa.org/fairness) explores the complex challenge of creating a sense of fairness in public finance and offers guidance on addressing issues of fairness. How revenues are raised and spent are two pieces of public finance with profound implications for fairness. GFOA's Rethinking Revenue and Rethinking Budgeting initiatives prioritize fairness as a key criterion for evaluating revenue sources and budgeting methods.

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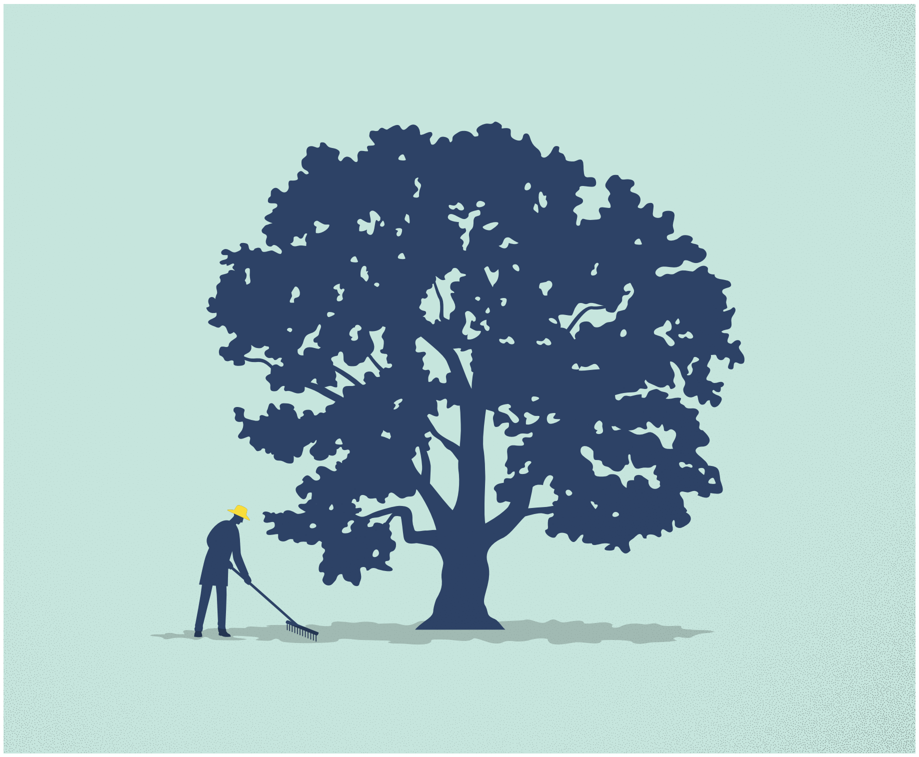

#4 UPHOLD STEWARDSHIP OF PUBLIC RESOURCES

First Principle: Manage public assets, liabilities, and resources with integrity, prudence, and a focus on creating and maintaining a thriving community for future generations. Avoid structural deficits.

Fundamental Truth: Public officials (elected and non-elected) are custodians of taxpayer resources and must act in the best interest of the community.

Application: It may be that most of GFOA's best practices derive from this first principle. The best example is "Treasury and Investment Management Best Practices." Public treasury best practices have long prioritized safety of principle. Liquidity and yield have been secondary and tertiary goals when making investment decisions. The primacy of stewardship is not limited to treasury.

In budgeting, a leading example is GFOA's best practice titled "Achieving a Structurally Balanced Budget." This encourages adopting rigorous policies for all operating funds and is aimed at achieving and maintaining a structurally balanced budget.

In accounting, we have "Internal Control Framework" from the Committee of Sponsoring Organizations (COSO) that serves as the basis for designing, implementing, operating, and evaluating internal control to provide assurance that operational, reporting, and compliance objectives are met.

Recently, GFOA has found that public funds are a "common resource"—a resource that is scarce but owned by the public. This presents challenges to stewardship that differ from those faced by a private entity. GFOA's Financial Foundations Framework (gfoa.org/fff) describes how to create and maintain financial health in light of the special challenges posed by common resources.

#5 CHAMPION FINANCIAL RESILIENCY

First Principle: Plan and act with a long-term perspective to ensure that fiscal policies and investments sustain public services and quality of life. Maintain flexibility in financial planning and management to adapt to unforeseen challenges, capitalize on new opportunities, and smooth out volatility.

Fundamental Truth: Financial decisions made today are generational and will affect the government's ability to meet its obligations and serve its constituents in the future. At the same time, the financial landscape is dynamic, with changing economic conditions, risks, and opportunities.

Application: The foremost example of a best practice that serves this first principle is "Fund Balance Guidelines for the General Fund." Fund balance acts as an insurance policy for unplanned and unavoidable losses, like those resulting from natural disasters. It also provides a savings account that can be used to seize opportunities that are not affordable in the current budget plan. For example, an opportunity might arise to acquire a valuable piece of land. Maybe the decision can't wait until next year's budget and there is not enough time to arrange debt financing. In such cases, having a well-managed fund balance ensures the flexibility to act quickly and responsibly.

Global interconnectedness has increased the perception of greater volatility and uncertainty. Whether the world is more volatile is a subject for debate, but some aspects unquestionably are. For example, the number of natural disasters have increased markedly over the past two decades. This affects a local government's reserve strategy. Furthermore, at a time when expertise is held in lower regard, the public and elected officials may be less willing to defer to standardized benchmarks on how much money should be held in reserve. For this reason, GFOA has developed methods to assess risks faced by local governments and translate them into a fund balance strategy.

#6 BE A DECISION ARCHITECT

First Principle: Decision making is hampered by "bias" and "noise." Bias reduces the rationality of decision making. Noise reduces the consistency of decisions. Help decision makers reduce the impact of bias and noise in decision making.

Fundamental Truth: Finance professionals impact decision making through the information they present, how it is presented, and the design of the decision making process. Perfect neutrality on the part of the finance officer is impossible. Finance officers should be deliberate in providing advice, sharing information, and creating an environment that helps decision-makers do their best work.

Application: The most common best practices for applying this first principle are those that advocate for establishing policies to guide decision making. Policies set boundaries on acceptable courses of action. Policies "pre-commit" to courses of action. For example, it's easy to agree that the local government should maintain a given amount of fund balance when the organization is not in a financial crisis or a budget shortfall. Pre-committing to good decisions when there is less pressure helps decision-makers perform at their best when the pressure is greater. Here are three examples of GFOA best practices that recommend establishing policy boundaries.

- "Adopting Financial Policies"
- "Capital Planning Policies"
- "Policies for Retirement Plan Design Options"

Decision architecture can go further than policy design. Advances in psychological and decision science research have highlighted the influence of cognitive biases and noise on decision making. For these reasons, GFOA has described the finance officer's role as a decision architect, including practices to help decision-makers do their best work. These practices include:

- **Widening the option set:** Help decision makers see the big picture and find a wider set of solutions rather than getting locked into a narrow set of possibilities.
- **Test assumptions:** Help decision makers identify uncertainties, and test assumptions before overinvesting in a program, asset, or course of action.
- **Find high-value options:** Help decision makers get the most bang for the buck.
- **Foster trust in the process:** The finance officer's ethos of objectivity puts them in a position to foster trust in good decision processes.

LEARN MORE

Read the GFOA report "Budget Officer as Decision Architect" to learn how budget officers can reduce the impact of bias and noise for better decision making.

gfoa.org/materials/budget-officer-as-decision-architect

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TENSIONS IN THE FIRST PRINCIPLES

Democracy contains tensions. The public finance first principles, as an instrument of democracy, also contain tensions. Exhibit 1 summarizes the primary tensions. In some cases, the headline tensions are taken directly from our first principles. In other cases, the headline tension is a concept implied by or derived from a first principle.

Let's illustrate with the first two tensions: accountability vs. flexibility and create value with public funds vs. preserve value of public funds. The first half of each tension is a direct statement of one of our first principles. The second half is derived. Flexibility is an essential part of principle number five, championing financial resiliency. Preserving the value of public funds derives from principle number four, upholding stewardship of public resources.

Unfortunately, there are no easy answers to resolving these tensions. At times, one may need to be chosen over the other. In such cases, the finance officer's ethics and political considerations guide the choice.

However, the takeaway should be that we, as people, tend to frame tensions as either/or choices more than necessary. Rather than seeing these tensions as either/or choices, finance officers should look for integrative solutions that combine the best of both principles.

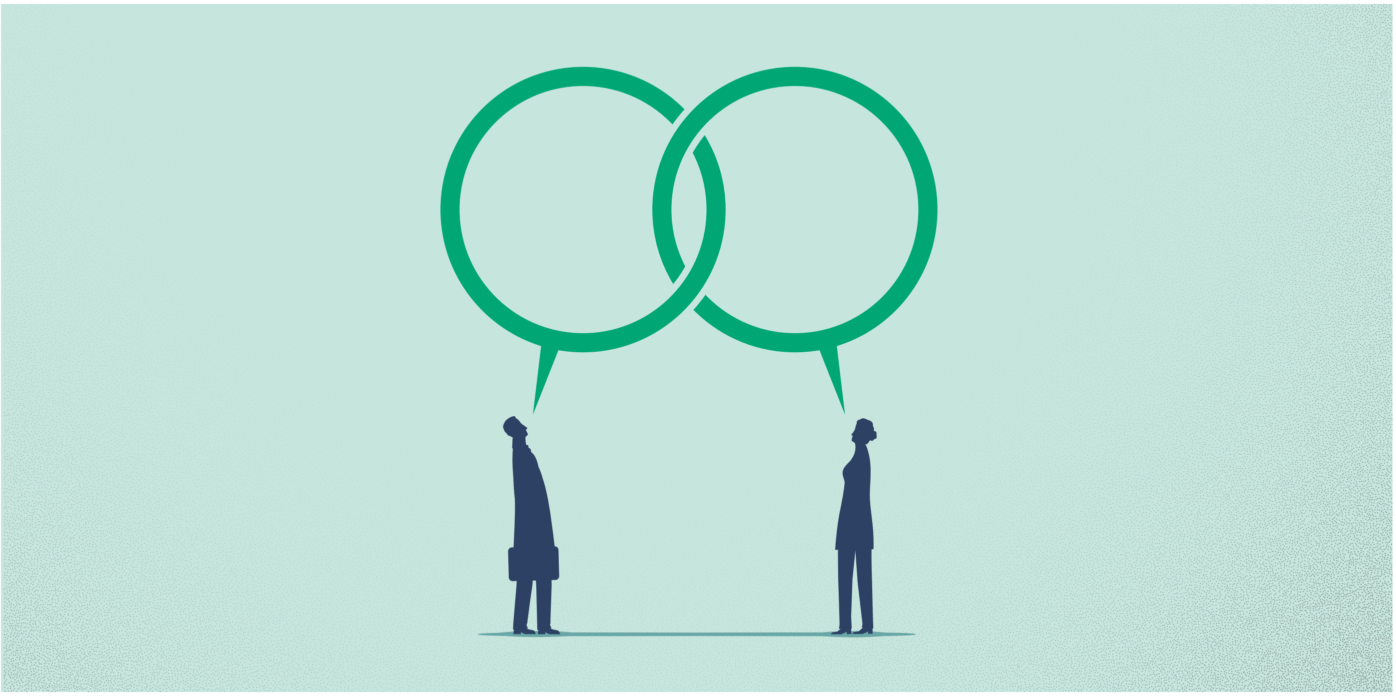
To illustrate, let's consider our fourth tension: trusted public servant vs. trusted public steward. This tension often arises during budget requests. Either side of this tension can be overemphasized. Overemphasizing the trusted public steward part of this tension can earn the finance officer a reputation as "Dr. No," as in "No, we can't spend that much money." This might result in the finance professional being sidelined or circumvented by frustrated public officials.

On the other side of this tension is the finance officer who always pulls the proverbial rabbit out of the hat—a hidden pot of money accessed just in time. Overemphasizing this side creates its own problems, including setting unrealistic expectations for the future, encouraging the finance officer to obscure the organization's available financial resources (to ensure a reliable supply of future rabbits), and relieving public officials of the need to exercise the skill of savvy decision making and making trade-offs.

EXHIBIT 1 | First Principles Primary Tensions

Accountability	**vs.**	**Flexibility**
People want consistent, predictable results from public servants.		Government needs to adapt to changing conditions.
Create Value With Public Funds	**vs.**	**Preserve Value of Public Funds**
Taxpayers deserve the best possible outcomes for their money. This requires the government to adapt and change, which often involves accepting some risk.		There are often asymmetric consequences of risks, making preservation of whatever value exists an attractive outcome. This encourages risk aversion.
Short Term	**vs.**	**Long Term**
The community and elected officials have real, pressing concerns that need to be addressed in the near term.		The government institution needs to endure for the community to thrive.
Trusted Public Servant	**vs.**	**Trusted Public Steward**
A trusted servant finds a way to get things done.		A steward sometimes has to say "no."
Democratic Control of Government	**vs.**	**Expert Management of Public Finance**
Local government is a democratic organization, so it must be responsive to the will of the public to be legitimate.		Public finance is a technical, complicated topic. The public interest is often best served by expert management of finances.
Create a Sense of Fairness With Public Finance	**vs.**	**Create Value With Public Finance**
Creating a sense of fairness often requires give and take, compromise, and consensus building. This slows decision making and may not result in the most technically elegant (much less optimal) outcome.		Creating the best value with public funds often requires capitalizing on opportunities, moving quickly, and finding the optimal way to execute on opportunities. This often leaves little room for compromise.

We, as people, tend to frame tensions as either/or choices more than necessary. Rather than seeing these tensions as either/or choices, finance officers should look for integrative solutions that combine the best of both principles.



Integrative solutions are possible more often than we think. Ask how you might find ways to get the best of both sides while avoiding the consequences of overemphasizing either.

The integrative solution to this tension might be answering, “Yes, if...” to spending requests, a recommendation we received from Rick Cole, chief deputy controller for the City of Los Angeles. For example, “Yes, we can fund that if we can find a new revenue source to pay for it or find offsetting savings elsewhere in the budget.” The finance officer can then present elected officials with options for achieving this.

Integrative solutions are possible more often than we think. When faced with one of these tensions, ask what you risk by overemphasizing one side. What might the unintended consequences be? Then ask what you risk by underemphasizing the other side. What are the opportunity costs? Finally, ask how you might find ways to get the best of both sides while avoiding the consequences of overemphasizing either.

CONCLUSION

First principles are the basis for any field, including public finance. They express a fundamental truth about public finance. They remain consistent despite technology and organizational characteristics of public finance that change over time. Understanding first principles is a necessary complement to knowing best practices. First principles provide the foundation for deviating from best practices when it becomes necessary. Public finance can’t advance unless best practices advance. Advancement can’t happen without change. Change can’t happen unless someone moves away from the then-current best practice. First principles provide the foundation for this evolution to occur, as everything we do in public finance should align with these first principles.

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