KEEPING THE LID ON AGGREGATE EXPENDITURE DURING BUDGET PREPARATION: ENFORCING AGGREGATE EXPENDITURE CEILINGS WHILE PRESERVING ALLOCATIVE FLEXIBILITY

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1 Overview

Aggregate *expenditure ceilings* are increasingly viewed by fiscal policy experts as an effective instrument for ensuring that the budget respects aggregate fiscal policy goals. It is generally (and correctly) held that the aggregate ceiling should be set in an *top-down* manner, which means that the ceiling is set at the start of the budget preparation process prior to any consideration of "bottom-up" spending requests from spending ministries. Once set, the aggregate ceiling should be *firm* – that is, it should essentially not be varied during the budget preparation process.

There is, in addition, growing support for the setting of firm *multi-year* aggregate ceilings, primarily as a means of preventing pro-cyclical increases in expenditure during the upswing of the business cycle.

Once having set aggregate ceilings, the challenge is to ensure that they are adhered to during the budget preparation process. The problem is, in other words, to make sure that *Ministry allocations* – the total amounts allocated to each Ministry – do not exceed the aggregate ceiling. This is no trivial matter. The imposition of the aggregate ceiling is intended to contain the upward pressure on spending arising from large numbers of "bottom-up" spending requests from ministries during the budget preparation process. However, unless processes exist to contain Ministry requests in some manner, budget decision-makers may be tempted to increase the aggregate ceiling during the budget preparation process in order to escape the tough zero-sum constraint imposed by an aggregate ceiling.

A widely-held view is that the solution to this problem is to set *Ministry (or sector) expenditure ceilings* in the same way as the aggregate ceiling. In this view, individual Ministry shares of the aggregate expenditure ceilings also should be set in a top-down manner before Ministry spending requests are considered. During the preparation of the annual budget, these Ministry ceilings should be quite firm, with ministries either barred or heavily discouraged from presenting spending plans which breach the ceilings they have been given.

There is a significant school which goes even further and suggests that firm top-down Ministry ceilings should be set not only for the coming budget year, but for the subsequent two or three years. This view contrasts with what is probably the more widespread position – that multi-year Ministry ceilings should be indicative (*i.e.*, relatively open to change).

This paper calls these views into question. It argues against setting Ministry allocations before ministries have the opportunity to formally present spending proposals. It also suggests that making medium-term Ministry ceilings firm (rather than indicative) is appropriate only in a minority of relatively advanced countries.

The key problem with an entirely top-down process for setting Ministry ceilings is that it can seriously undermine the pursuit of allocative efficiency, by making Ministry shares of the aggregate expenditure ceiling more rigid. These budgeting techniques might appear to score high on the criterion of aggregate fiscal discipline. But budgeting techniques should not be judged solely

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on this criterion, but also on the extent to which they promote improved expenditure effectiveness and efficiency. Microeconomic considerations should be given as much weight as macroeconomic.

In the light of this, the paper turns its attention to the best means of resolving the tension between a purely top-down aggregate ceiling and the bottom-up pressure for spending increases during the budget preparation process. It outlines certain budget preparation techniques which can ensure that Ministry allocations do not in total exceed the aggregate ceiling while at the same time preserving and enhancing flexibility in the reallocation of resources between ministries. In particular, it argues for:

- the use of the top-down approach to setting Ministry *baseline* ceilings – that is, the component of budget allocations designed to cover existing programs and capital projects;
- the treatment of the available *fiscal space* – the funds available for new expenditure policy initiatives or new capital projects – as a government-wide pool, to be allocated during the budget process taking into account Ministry proposals;
- the systematic scrutiny of Ministry baseline expenditure via spending review to increase fiscal space via efficiency savings and the reallocation of funds away from low priority and irredeemably ineffective programs.

The structure of the paper is as follows. Firstly, the scene is set by clarifying the concept of expenditure ceilings, and briefly noting the benefits of setting an aggregate ceiling. After this, the focus shifts to the process for setting Ministry allocations consistent with the aggregate ceiling. The notion of top-down setting of Ministry ceilings is critiqued, and an alternative approach outlined. In this context, brief consideration is given to the situation of less advanced countries which may not be able to fully implement relatively sophisticated budget preparation techniques. The paper then turns to the question of medium-term Ministry ceilings, considering the preconditions for an effective system of firm medium-term ceilings, and the implications of this for countries which do fulfill those preconditions. Concluding remarks follow.

2 What is an expenditure ceiling?

Expenditure ceilings are upper limits on the amount of expenditure which are set for specific years, and which are applied during the budget preparation process. For example, if government decides early in the budget preparation process that aggregate government expenditure excluding interest payments will not exceed \$324.05 billion in the coming year, it is setting an expenditure ceiling. Expenditure ceilings should not be confused with the expenditure limits set by parliament when it passes the budget law, which limit expenditure only during the execution of the budget. An expenditure ceiling constrains budget preparation *as well as* budget execution.

An aggregate expenditure ceiling is a limit which covers all or most government expenditure.[1] A Ministry ceiling, similarly, covers all or most of the Ministry's expenditure.[2]

A *firm* expenditure ceiling is, roughly speaking, a ceiling which is intended to be fixed and not open to variation during the budget preparation process.[3] By contrast, an *indicative* ceiling is a

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1 It might exclude certain categories of expenditure such as interest payments.

2 It might exclude certain categories of ministry's spending such as entitlements expenditure which is determined by law (on the grounds that the ministry has no control over the volume of such payments).

3 If we wished to be more precise, we would acknowledge that no ceiling can be absolutely binding, and that the intended firmness of an expenditure ceiling is a matter of degree, referring to how limited or extensive the circumstances are under which the ceiling might be modified. A more precise definition of a firm ceiling would then be a ceiling which policymakers intend to respect other than in very limited or exceptional circumstances, which certainly do not include the presentation by ministries of a large number of attractive new spending proposals.

ceiling which is understood as being open to some degree of modification during budget preparation but which is nevertheless expected to have some constraining impact on the levels of expenditure approved in the budget when it is finalized (otherwise it would not make sense to call it a "ceiling"). Both types of ceilings may be contrasted with expenditure forecasts – also known as *forward estimates* – which are mere projections and are not intended to influence or determine in any way the future evolution of expenditure.

Expenditure ceilings are different from *expenditure rules*, which may be defined as *limits on expenditure which are formulated in such a manner as to have continuing application*.[4] A commitment that government expenditure will not exceed 35 per cent of GDP is, for example, an expenditure rule. Expressed differently, an expenditure ceiling which applies to year n implies nothing about the limit, if any, which might apply to year $n + 1$. By contrast, an expenditure rule is formulated in such a manner as to apply to both years and subsequent years.[5]

Any expenditure rule must be given effect through the setting of expenditure ceilings for specific years. So if there is an expenditure rule, there must also be expenditure ceilings. The converse is not, however, true – expenditure ceilings may be set even if there is no expenditure rule.

3 Why aggregate expenditure ceilings?

As noted above, the fundamental rationale for setting aggregate ceilings is to ensure that the Ministry allocations decided in the budget preparation process are consistent with aggregate fiscal policy objectives. In the top-down process, the highest executive budget decision-making institution (which we will call the "Cabinet" as shorthand[6]) sets the aggregate ceiling which reflects macro-fiscal and revenue policy objectives prior to any consideration of Ministry spending requests (Ljungman, 2008).

On the other hand, the main rationale for setting *multi-year* aggregate ceilings is to ensure that expenditure does not rise in tandem with purely cyclical revenue increases during the boom phase of the business cycle – in a way which would be possible if only budget deficit rules applied – leading to the structural deterioration of public finances. Multi-year ceilings can, however, also support medium-term debt reduction or tax reduction objectives (EC, 2010). To achieve these objectives, it is clearly important that the multi-year ceilings are firm rather than purely indicative. The use of firm multi-year aggregate ceilings was pioneered by Sweden, Finland and the Netherlands, but is increasingly now being extended to other countries. Denmark, for example, has a project underway at present to develop such ceilings broadly along Swedish lines. International organizations are also increasingly advocating the use of medium-term expenditure ceilings or rules. In the post financial-crisis world, medium-term aggregate expenditure ceilings are viewed as a potentially useful instrument for fiscal consolidation.

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4 This is consistent – subject to one qualification – with the IMF's definition of expenditure rules (IMF, 2009: 5) as "permanent limits on total, primary, or current spending in absolute terms, growth rates, or in percent of GDP", which is in turn consistent with the widely-accepted Kopits-Symansky (1998) definition of a fiscal rule (of which an expenditure rule is one type) as "a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance". The qualification is the substitution of "continuing" for "permanent" application. This recognizes that a rule might be intended to apply indefinitely, or for a defined period of time, without necessarily being permanent.

5 The distinction between expenditure rules and expenditure ceilings is a matter upon which there is some confusion. For example, while the European Commission defines expenditure rules in accordance with the Kopits-Symansky definition of fiscal rules, it inconsistently treats expenditure ceilings as a type of expenditure rule (see, e.g., EC, 2009: 87, 90, 268-9 and EC 2006: 162).

6 Of course, the highest decision-making institution on budgetary matters differs with the political system, and in some cases is not the Cabinet (council of ministers) but, say, the president.

4 Setting Ministry shares of the aggregate ceiling

Once the case for aggregate ceilings is accepted, the question arises of how to operationalise them in the budget preparation process. Within what we might call the public financial management (PFM) technical assistance community, it is widely held that the answer is a two-stage budget preparation process in which, firstly, both the aggregate *and* Ministry ceilings are set by the Cabinet and, secondly, ministries prepare detailed budgets within the ceilings given to them. In Tommasi's words (2010, p. 89), there should be:

- "A 'framework' stage – often referred to as the 'strategic' phase – during which are determined the overall budgetary objectives (total expenditure, deficit, etc.) and the sectoral allocation of resources, including Ministry expenditure ceilings…
- A stage of preparation by ministries of detailed expenditure estimates which respect the Ministry ceilings which were set … during the strategic phase."

In this formulation, the determination of Ministry ceilings becomes, like the setting of the aggregate ceiling, a top-down process in which ministries are quite deliberately excluded from presenting spending proposals before the Ministry ceilings are set. The "bottom up" part of the budget preparation process is entirely or largely restricted to ministries making proposals as to how they will spend their respective ceilings (De Renzio and Smith, 2005; Kim and Park, 2006, p. 88). As this implies, the Ministry ceilings, once set, are entirely or at least "reasonably" firm during the preparation of the annual budget (World Bank, 1998, p. 47).

A variant on this approach calls for firm *sectoral* ceilings, rather than Ministry ceilings, to be set in a top-down manner at the strategic stage. Sectoral ceilings cover several ministries, and in this variant of the process the allocation of each sectoral ceiling between sector ministries is determined in the second stage of the budget preparation process (e.g., Schiavo-Campo and Tommasi, 1999, Chapter 4, p. 8). This model draws its inspiration from the "sector-wide" approach which Canada briefly applied to the expenditure allocation process before abandoning it (Good, 2007, pp. 256-8). For simplicity, this paper focuses on the version of the model which requires the top-down determination of *Ministry* ceilings. However, the problems discussed here apply equally to the sector ceilings version of the model.

This top-down approach to setting Ministry or sectoral ceilings can be traced back to the seminal World Bank *Public Expenditure Management Handbook* (World Bank, 1998, p. 89).

In the standard model of the Medium-term Expenditure Framework (MTEF) originally introduced in the Bank's *Handbook*, top-down Ministry ceilings are set not merely for the coming budget year, but for the following two or more years. The *Handbook* held that such *multi-year* Ministry ceilings should be indicative rather than firm, and that probably remains majority opinion within the PFM technical assistance community – although it has to be said that there is a widespread lack of clarity on just how firm medium-term ceilings are supposed to be.

There are, however, many who believe that not only annual Ministry ceilings, but also outer year Ministry ceilings, should be firm. As Kim and Park (2006, p. 95) put it, many advocates of top-down budgeting consider that "the top-down budgeting system cannot work as expected without an effective medium-term budget framework … [which is] operationalised by establishing *hard* budget constraints for individual ministries and programmes over a span of multiple years" (italics added).

The analysis which follows examines, firstly, the proposition that Ministry ceilings should be set in a top-down manner. It then critically assesses the proposition that medium-term Ministry ceilings should be firm rather than indicative.

5 Top-down setting of Ministry ceilings?

The conventional case for using a top-down process to set Ministry ceilings is that excluding the presentation of Ministry spending proposals prior to the determination of Ministry ceilings

- prevents the Ministry of Finance (MOF) from being overloaded by large numbers of new spending proposals which in aggregate greatly exceed available resources and which it is beyond the resources of the MOF to review properly,
- saves spending ministries from wasting a great deal of effort preparing and costing spending proposals which have no chance of being funded given available resources, and
- greatly reduces the likelihood that the political leadership will succumb to bottom-up pressure during the budget preparation process by deciding to increase the aggregate ceiling.

It is crucial to note that only *firm* Ministry ceilings could be expected to constrain new spending requests in this manner and thus produce the alleged benefits of the top-down ceiling-setting process. If ministries knew that ceilings were indicative and therefore open to modification, they would presumably not hesitate to present additional spending proposals in excess of the ceilings.

As attractive as the case for firm top-down Ministry ceilings might appear to be from point of view of aggregate expenditure control, there is a major downside. This is that determining Ministry ceilings without any consideration of bottom-up Ministry requests must inevitably undermine allocative efficiency. Allocative efficiency means choosing from the available alternative expenditure options those which will deliver the greatest benefits to the community. Choosing the best available spending options requires prior knowledge of what those options actually are, and such knowledge will for the most part not be available to the Cabinet and MOF if spending ministries are barred from putting new spending proposals forward. Expressed differently, the information constraints facing central decision-makers are so great that only with the assistance of extensive bottom-up expenditure proposals can they have any hope of doing a reasonably good job of allocating budgetary resources.

It is true that advocates of the top-down setting of Ministry ceilings envisage that, even though bottom-up requests are to be banned, the ceilings will nonetheless be set “according to policy priorities” (e.g., Kim and Park, p. 88). What this usually means is that during the “strategic” phase of budget preparation Cabinet identifies the areas of government services to which it wishes priority to be given in the allocation of resources – presumably based on the emergence of new policy challenges or on changed views about priorities – and then sets the Ministry ceilings based on these priorities. The problem with this is that the mere identification of priorities to which the budget should pay attention does not provide sufficient information to appropriately determine specific Ministry ceilings. Ministry ceilings can only logically be set in the knowledge of the specific new program/projects options which can give effect to those priorities. Concrete new program/project proposals must, in the main, come from the relevant spending ministries: in other words, they must be bottom-up.

It is undoubtedly good practice for Cabinet to discuss expenditure challenges and priorities during the strategic phase of the budget preparation process, and to inform spending ministries of the government priorities it wishes to see reflected in their spending requests. But it makes no sense for Cabinet to proceed directly from the consideration of priorities to the determination of Ministry ceilings, skipping any intervening consideration of concrete spending proposals.

One should, in any event, be very cautious about the *feasibility* of an entirely top-down determination of Ministry ceilings. In practice, it is not possible to prevent some major new spending proposals from ministries from being put forward during the discussions leading to setting of supposedly “top down” Ministry ceilings. While a top-down process might eliminate the presentation of *formal* Ministry budget requests prior to the establishment of Ministry ceilings, it would certainly not eliminate the *informal* presentation of major new spending proposals. It is to be expected that in the Cabinet discussions during the strategic phase of the budget preparation process, individual ministers would argue for increased ceilings for their own ministries largely by referring to significant new spending proposals which they would like to see funded. There is also likely to be considerable behind-the-scene lobbying of the president/prime minister, again based in large measure on specific new spending proposals.

What this means is that the supposedly top-down process of setting Ministry ceilings ends up leading to the replacement of *formal* processes for the consideration of bottom-up spending proposals with *informal* processes. This is undesirable. One of the hallmarks of a good budget preparation process is the existence of clear formal routines for the presentation and appraisal of new spending proposals. These routines should include the requirement that all new spending proposals are presented with prescribed supporting information in a standard format, as well as a standard process for the review of such spending proposals by the MOF and other relevant “central agencies” such as the office of the president or prime minister. By encouraging the informal presentation of major new spending proposals during the strategic phase of the budget preparation process, the supposedly top-down process undermines these formal routines. The inevitable result will be the *de facto* approval of major initiatives by Cabinet without the benefit of formal submissions or detailed critical analysis by central agencies.[7] In addition, because the time available for discussion during the Cabinet discussion during the strategic phase of the budget preparation process will inevitably be very limited, it is likely that only a handful of the most powerful ministers will enjoy the opportunity to raise new proposals which influence Ministry ceilings.

6 How firm are the top-down Ministry ceilings?

It is therefore hardly surprising that in practice – as Kim and Park (2006, p. 94, pp. 107-8) make clear – a number of countries with supposedly top-down processes for setting Ministry ceilings in fact permit bottom-up new spending proposals before finalizing the ceilings. A typical example of this is Denmark where, according to Blondal and Ruffner (2004, p. 58):

> *Spending ministries ... submissions are [supposed] to be in line with the expenditure ceilings given to them in February. In reality, the amounts are generally in excess – either due to the ministries claiming that the cost of operating unchanged policies is higher than what was assumed, or because they will be making claims for new initiatives. ... There are strong procedures in place to justify any bids in excess of the initial expenditure ceilings allocated.*

Sweden is supposedly the poster-boy for top-down Ministry ceiling-setting. In theory the Ministry ceilings are all set at a Cabinet retreat one month into the budget preparation process, prior to any bottom-up input, and these ceilings then remain firm. In practice, however, ministries do present budget requests in excess of their top-down ceilings (Gustafsson, 2004, p. 63).

The advocates of *firm* top-down Ministry ceilings have considerable difficulty with this issue, and cannot be said to present a clear and consistent line. The World Bank’s *Handbook* asserts that the “test of these envelopes [*i.e.*, ceilings] is their credibility … It would be expected that they would [be] reasonably firm for formulation of the annual budget”. The ambiguity of the word “reasonably” is notable, but it is clear that the emphasis is on firmness. Yet a couple of years later

[7] In addition, the resource allocation bias towards the most politically powerful ministers would be exacerbated, because only they would in general have the weight to be able to raise major new spending proposals.

the principle author of the *Handbook* and architect of the MTEF concept (Malcolm Holmes) is to be found quite correctly rejecting the notion

> *... that ceilings should be immutable once set at the outset of budget preparation. On the contrary, a central purpose of the budget preparation process is to ensure that resources are going to priorities and reflect information on what is working and what is not.* (Holmes and Evans, 2003, p. 24).

A similarly contradictory position can be seen in Schiavo-Campo and Tommasi (1999, Chapter 4, pp. 34-5) who, immediately after arguing for a completely top-down process of setting firm sector ceilings ("definite budgetary envelopes") in developing countries, contradict themselves by conceding the possibility that "additional requests from line ministries could be allowed for new programs", in which case only "the principal request [from the Ministry] should be consistent with the notified ceilings".

Holmes and Evans (2003, p. 35) try to square the circle by arguing that "ceilings must be sufficiently fixed … to be credible but sufficiently flexible to accommodate changing economic conditions, changing priorities and new information". But this is surely an impossible balancing act. If there is to be significant flexibility to reallocate resources between sectors or ministries, or if significant new policy proposals outside the initial supposedly top-down Ministry ceilings are permitted, the system is no longer one based on firm Ministry ceilings, but rather one based on indicative ceilings. And no longer is it reasonable to expect that the ceilings will achieve their aim of preventing ministries from putting forward substantial numbers of new spending requests. The supposed advantages of top-down budgeting over bottom-up budgeting disappear.

One searches in vain in the works of advocates of supposedly firm top-down Ministry ceilings for any principles which determine how much money is to be made available for new spending proposals, and how this is to be taken into account when the Ministry ceilings are initially set. One is therefore left without any explicit mechanism for ensuring that the initial Ministry ceilings, plus new policy proposals accepted later in the budget preparation process, are consistent with the aggregate ceiling.

Potter and Diamond (who are advocates of *indicative* Ministry ceilings) explicitly address the question of availability of funds for new policy proposals in excess of initial Ministry ceilings in their classic budgeting manual. They suggest a "planning reserve" of 1-2 per cent of the aggregate ceiling "so the Ministry of finance can assign extra resources later during budget negotiations for the most urgent priorities, without breaching the" aggregate ceiling (Potter and Diamond, 1999, p. 18). They are undoubtedly on the right track here in suggesting a government-wide pool of funds for new policy (see further on this below). However, with a "planning reserve" which is so very small, their proposal remains a recipe for allocative rigidity and incrementalism. The size of the reserve also seems entirely arbitrary, without any clear relationship to the underlying fiscal space available to government.

All these considerations point to the conclusion that the top-down setting of Ministry ceilings, prior to the consideration of formal new spending requests from spending ministries, is in general undesirable and impractical. A sound budget preparation process must preserve channels by which ministries can formally present new spending proposals prior to the finalization of Ministry ceilings, with those proposals being then subject to rigorous analysis and challenge by the MOF and other relevant central agencies. This conclusion is not changed by the fact that the exigencies of a major fiscal consolidation may justify the temporary adoption of a more top-down approach.

7 How to reconcile an aggregate ceiling with allocative flexibility

What type of budget preparation process is capable of reconciling allocative efficiency with aggregate expenditure ceilings? How can the budget preparation process be organized to give effect to aggregate ceilings while retaining maximum flexibility to allocate budgetary resources to where they will deliver the greatest social benefit? There is no single answer to this question which can be applied to all countries. Differences in technical capacity and institutional structure mean that one size does not fit all. Nevertheless, it is possible to draw on the experience of certain leading countries in order to present a stylized best-practice model which can at least provide a starting point for thinking about how to reform the budget preparation process in specific countries.

The model takes as its starting point the distinction between new spending and "baseline" spending on ongoing programs and projects. In respect to the former, allocative efficiency requires a budget preparation process which can allocate the resources available for new spending – the *fiscal space* – to those programs and ministries where they will be most useful. This requires that the resources available for new spending (interpreted to include discretionary expansions of existing programs) are treated as *government-wide pool*, the allocation of which is based on the careful evaluation of the alternative spending options.

As a first approximation, fiscal space can be allocated in this way while respecting the aggregate ceiling through a budget process in which:

- firm baseline ceilings providing funding for existing programs and capital projects are established for each Ministry at start of budget process, in an entirely top-down process;
- a firm government-wide new policy ceiling is set at the same time, equal to the aggregate ceiling minus the sum of Ministry baseline ceilings.

The allocation of the new policy ceiling between ministries would then be determined during budget preparation, based on both government priorities and bottom-up Ministry proposals. The political leadership would provide guidance for the allocation process by considering its overall priorities at the start of the budget preparation, without at that stage setting Ministry ceilings.[8] Ministries would then make detailed formal bottom-up submissions for concrete new spending proposals, which would be subject to searching independent analysis by the central agencies.

In respect to baseline expenditure, this process would, ideally at least, be entirely top-down. That is, the baseline spending requirements of ministries would be calculated by the MOF without any consideration of requests from the spending ministries. "Bottom-up" budget requests would be confined to new policy. Moreover, a clear constraint would have been set on the total value of new spending proposals which could be accepted.

Such a process would score high points for allocative efficiency *in respect to new spending*. This is not, however, enough. Allocative efficiency also requires a capacity to re-examine and reallocate baseline expenditure. A process in which Ministry baseline ceilings were set in concrete at start of the budget preparation process would unnecessarily limit the scope for such re-examination and the allocation. Expressed differently, it would institutionalize budgetary *incrementalism* (Schick, 2009, p. 2).

The "first approximation" process as outlined above has the further disadvantage of being based on the assumptions that fiscal space estimated in this manner will always be:

- positive – *i.e.*, that the sum of Ministry baseline ceilings will always be less than the aggregate ceiling, and

[8] What this would mainly mean in practice is that the leadership would identify particular key problem areas which it would like to see addressed via new spending in the budget.

- sufficient to provide scope for those new spending items which government regards as high priority.

If these assumptions do not hold, the only way of respecting the aggregate ceiling and/or giving effect to government priorities is to reduce budget allocations to existing services – that is, to cut Ministry baseline ceilings. This type of situation is particularly likely to arise during phases of fiscal consolidation, when aggregate ceilings will be set at levels which require significant spending cuts.

These considerations point to the need to incorporate into the budget preparation process a mechanism which makes it possible to review and cut baseline funding. An enhanced process consistent with this is one in which Ministry baseline ceilings are subject to possible reduction as the result of a *spending review* process and, more specifically:

- when set at the start of the budget preparation process, Ministry baseline ceilings may already incorporate cuts to existing programs (e.g., as the result of any spending review conducted prior to the commencement of the budget preparation process).
- during the budget process, Ministry baseline ceilings are potentially subject to further cuts – making them firm in the upward direction but flexible downwards.

Any cuts to baseline ceilings will then increase the amount of fiscal space available to fund new policy.[9]

This transforms the new policy ceiling set at the start of the budget process into a *net* ceiling in the sense that it limits *net* new spending – *i.e.*, new spending *minus* any cuts to existing programs decided during the budget process.

This remains a highly top-down process, in which two types of firm ceiling are set right at the start of the budget preparation process prior to Ministry funding requests. At the same time, it is a process which has the advantage not only of avoiding incrementalism, but also of explicitly linking decisions about the amount of new spending to the matching decisions taken during the budget preparation process on cuts in baseline spending. This provides a pressure valve which permits the acceptance, if appropriate, of additional new spending proposals without raising the aggregate ceiling. To make this work, it is necessary for the MOF to maintain throughout budget preparation a running tally of the net impact of new spending and cuts.

Such a system maximizes allocative flexibility while ensuring respect for the aggregate ceiling. The capacity of countries to realize the benefits of such allocative flexibility will depend upon how good they are at spending review and the extent to which they have adopted the principles of performance budgeting.

In summary, this is a budget preparation process based on two key principles. The first is the separation of decisions on net new spending – *i.e.*, new spending initiatives and expenditure cuts – from decisions about baseline funding for continuing programs. The second is the imposition throughout the budget process of the constraint that *net* new spending must not exceed the aggregate expenditure ceiling minus baseline funding.

What about the top-down budgeting objective of preventing spending ministries from over-burdening the budget process with too many new spending proposals? The existence of an explicit new policy ceiling helps, but a government-wide pool for new spending will necessarily attract competing "bids" in excess of the amount available. Particularly important therefore is the rigor of the information and analysis requirements which ministries are required to meet in their formal

[9] It should be noted that the potential downward flexibility of ministry baseline ceilings raises significant issues. These are perhaps best resolved in the Danish manner of excluding from the baseline ceilings specific programs which have been identified as the subject of spending review during the budget cycle. This requires a programmatic budget structure.

submissions for new spending proposals. If these are tough, they will significantly reduce the number of new policy proposals. In addition, the indication of the government's priority areas for new spending by the political leadership at the commencement of the budget preparation process should act to discourage – without totally preventing – ministries from presenting new spending proposals outside these priorities areas. Finally, certain supplementary budget process rules – such as an expectation that ministries will fund *minor* new spending proposals through internal savings rather than funding requests – can help to contain the numbers of new policy proposals to manageable levels.

8 Technical capacity and the process for setting Ministry allocations

In its pure form, the process outlined above requires quite advanced technical capacity in one important area: the preparation of reasonably accurate expenditure "forward estimates". Forward estimates are projections of expenditure (and revenue) on a "current policy" basis – that is, projections of future levels of expenditure and revenue on the assumption that there are no new spending initiatives, no changes to tax laws, and all explicit and clear commitments made to future expenditure (including political promises) are taken into account.[10]

The ability to prepare accurate forward expenditure estimates at least one year ahead is essential if Ministry baseline ceilings are, as suggested above, to be set in a purely top-down manner. This is because, if spending ministries are to be denied the opportunity to present their own views about the funding they need to continue "current policy" before Ministry baseline ceilings are set, the MOF needs to be very confident that its own estimates of baseline requirements are accurate.

There are, however, many countries which are unable to prepare accurate forward estimates even one year ahead. Under these circumstances, to set Ministry baseline ceilings in a purely top-down manner is clearly not feasible. Bottom-up representations from spending ministries on their baseline requirements cannot be denied.

In at least some countries, a modified version of the process for setting Ministry baseline ceilings outlined above is, however, practical. In such a process, the MOF initially sets *indicative* Ministry baseline ceilings which are as accurate as it is able to make them, but gives spending ministries the opportunity to formally request the revision of these ceilings. Crucially, however, the MOF tightly prescribes and limits the grounds upon which such revision may be requested. The most important of these would be *mandatory* expenditure requirements of which the MOF was not aware.[11] In such a process, the MOF permits bottom-up input into the determination of Ministry baseline expenditure allocations precisely because it is aware that its expenditure forecasting capacity is not (yet) good enough to permit it to determine those baseline allocations unilaterally. However, with such an approach, MOF expenditure forecasting capacity improves over time, and the setting of baseline allocations can become increasingly top-down.

Such an approach recognizes something which is not acknowledged by most advocates of top-down budgeting – namely, that the degree to which budgeting can be made top-down is in part a function of the technical capacity of the country concerned. It is inappropriate to advocate equally top-down processes everywhere in the world.

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[10] They are known by a range of other names, such as "annual reference level update" in Canada and "consequence estimates" in Sweden.

[11] A mandatory expenditure requirement is an obligation to change the volume of services or transfer payments provided to citizens because of a legal requirement or an explicit government policy.

9 Multi-year Ministry ceilings

As noted at the outset, there are those who believe that not only annual, but also multi-year, Ministry ceilings should be firm. Those of this opinion tend to look to the practice of the handful of advanced countries such as the United Kingdom where governments make firm medium-term budget commitments to ministries. Firm multi-annual Ministry ceilings are seen by their proponents not only as tools for expenditure discipline, but as a means of improving performance by providing ministries with certainty about future funding levels. Such certainty allows ministries to plan and manage on a medium-term basis.

The potential benefits of giving ministries medium-term funding certainty are clear, but there are two main obstacles which make this approach impractical in the majority of countries.

The first is, once again, the quality of forward estimates. If firm multi-year Ministry ceilings are to be set, the MOF needs to be able to prepare accurate forward estimates of the "current policy" expenditure requirements of ministries not merely for the coming year, but for several years into the future. If a country is unable to prepare reasonably accurate medium-term forward expenditure estimates, there will be a high risk that the ceilings set for many ministries in the outer years will be either too low or too high. This is not a problem if the ceilings are only indicative, but it is a major problem if they are firm. If the ceilings are too high, the available fiscal space will be underestimated and the capacity to fund new policy commensurately reduced. But if they are too low, the risk will be that, when the outer years arrive, the unrealism of the supposedly firm Ministry ceilings will become apparent and the ceilings will end up being modified upwards. Expressed differently, the ability to make firm multi-year Ministry ceilings stick depends upon the credibility of those ceilings.

Experience has amply demonstrated that poor quality forward estimates undermine the entire medium-term budgeting process. Countries which have attempted to introduce MTEFs without investing significant effort in the forward estimates process tend, unsurprisingly, to have been disappointed with the results. In the absence of a system and capacity to produce quality forward estimates, projections of medium-term aggregate spending and revenue tend to be prepared on the basis of the crudest techniques (e.g., updating based only on the application of a general inflation factor) which fail to capture the dynamics of current policy. And the inevitable consequence is that the medium-term sectoral or Ministry "ceilings" which are prepared on the basis of those forward estimates and approved in the MTEF have little impact on the actual expenditure approved in annual budget.

Arguably, countries which are unable to prepare forward expenditure estimates should not pretend to be setting even indicative ceilings. A better approach for such countries would be to initially focus only on producing medium-term *forecasts*. Only at the point where these forecasts attain an acceptable degree of accuracy should they be used to set indicative ceilings.

The other danger of setting *firm* multi-year Ministry ceilings is that it will greatly increase allocative rigidity. Locking in Ministry ceilings for, say, three years into the future means denying oneself the ability to reallocate resources during that period in accordance with priorities and performance. Unless the country concerned is very good at periodic in-depth reviews of expenditure priorities, the result is likely to be that ministries and programs which should have their funding cut will find themselves more protected from cuts, and ministries and programs which should receive greater funding will find it even harder to attract additional resources. The UK combined its system of firm multi-year Ministry ceilings with periodic in-depth spending reviews. However, spending review – the critical examination of baseline expenditure to identify wasteful and low priority spending which can be cut to free up additional fiscal space – is something which only a minority of countries around the world are good at. Moreover, undertaking a *major* spending

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Fölscher (2007, p. 5) notes that in Africa: "the quality of forward estimates is poor. They consist far too frequently of the proposed budget for the first year of a multi-year framework, followed by inflation adjusted projections of cost for the outer year ... they pay little attention to, for example, the likely phasing of policy implementation, changes in demand that will effect spending unevenly or the impact of once-off capital spending on the base-year estimates. ... A key aspect of embedding a medium-term perspective therefore is deciding what the rules are for rolling over and adjusting and determining the forward estimates".

Another typical example of the way in which poor quality forward estimates have undermined the value of medium term budgeting in developing countries is Kyrgyzstan, where a 2008 IMF ROSC (fiscal transparency) review noted that "the costs of government policies and programs are yet to be tracked with an acceptable degree of accuracy to serve as the basis for a well-developed forward estimates system and systematic preparation of the Medium Term Budget Framework" (IMF, 2008, p. 16). The following year, a "PEFA" review made the following observation: "starting from 2009 the annual budget law is produced for three years on a rolling basis. It is too early to assess the impact of these changes, but it seems that the budgets for the second and third year are merely projections on the basis of expected inflation" (Shambetova *et al.*, 2009, p. 38).

review every three years is more demanding that undertaking *some* spending review every year. It follows that developing strong spending review capacity should be seen as a prerequisite (along with good forward estimates) for moving to *firm* multi-year Ministry ceilings.

10 Conclusion

Setting Ministry ceilings in a completely top-down manner and then insisting that they be firm – possibly even on a multi-year basis – is superficially attractive to those who focus solely on aggregate fiscal discipline. However, it is crucial – particularly at a time when the need to restore public finances after the financial crisis and meet longer-term structural fiscal sustainability challenges looms large – not to lose sight of the fact that good budgeting is not only about fiscal discipline, but also about allocative efficiency.

This paper has aimed to show that it is possible to enforce firm aggregate expenditure control via aggregate expenditure ceilings while maximizing the allocative flexibility of the budgeting system. The keys to this are: the baseline/new policy distinction, good forward estimates, a government-wide new policy pool, and spending review. The paper suggests an alternative form of top-down budgeting in which it is not Ministry ceilings which are set at the start of the budget process but rather Ministry *baseline* ceilings and the government-wide new policy pool.

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