



Fiscal Futures, Institutional Budget Reforms, and Their Effects

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OECD

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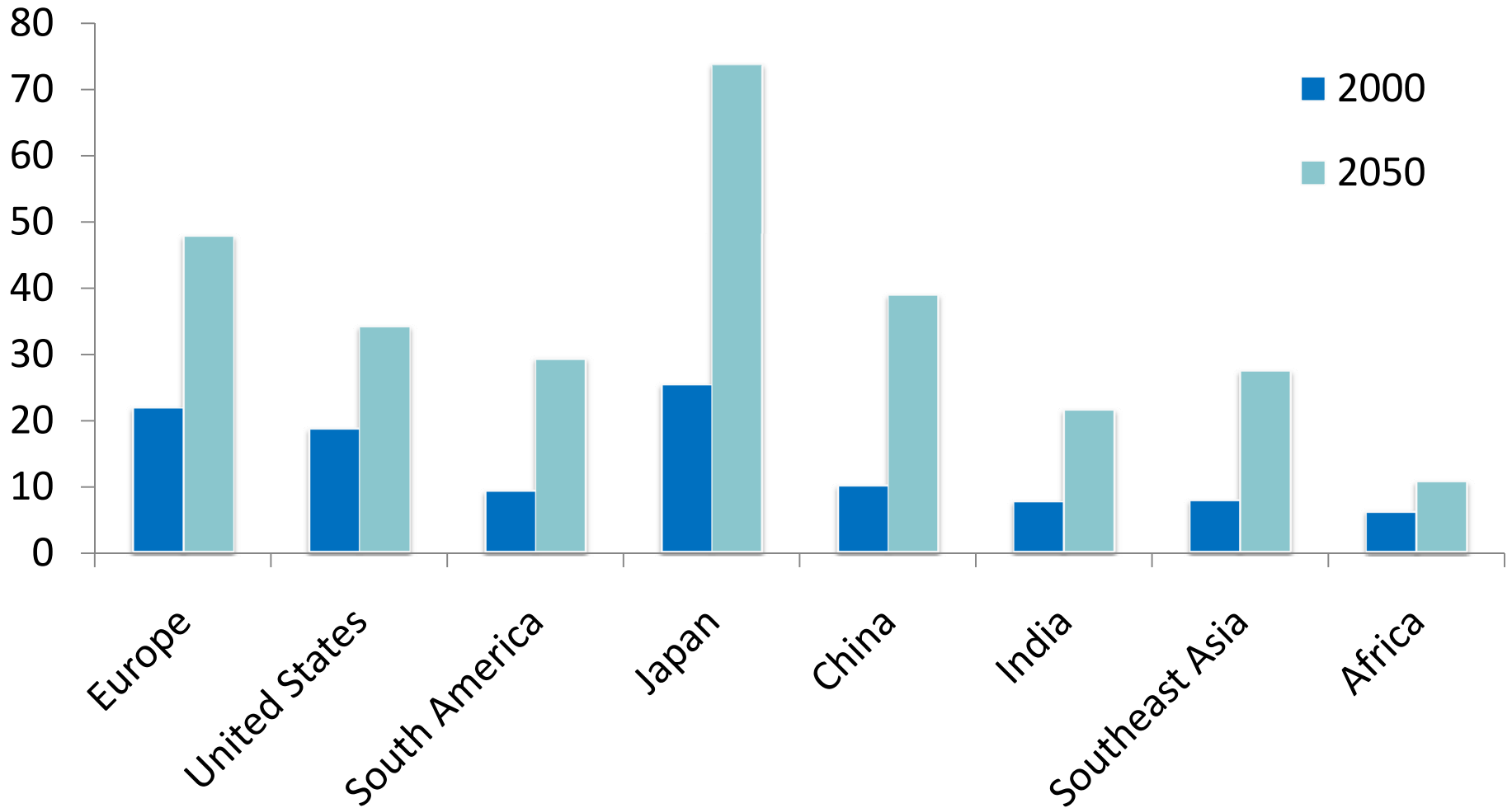
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Countries Around The World Are Facing Long-Term Fiscal Challenges

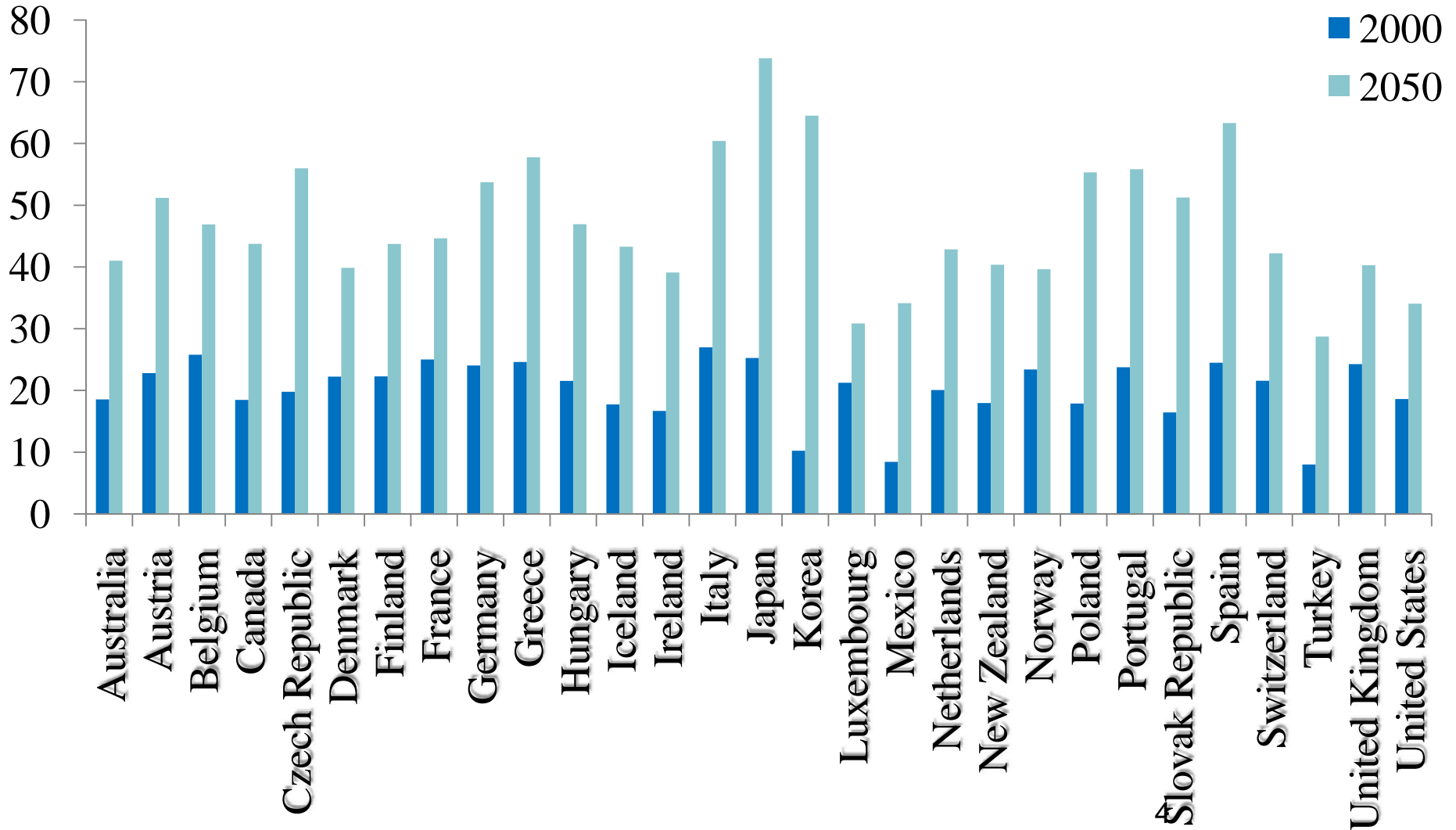
- Pension, health care, & other services expected by ageing (& sometimes smaller) populations
- The risks imposed by climate change & natural disasters
- The costs of contingent liabilities inherent in government programs such as:
 - Loan guarantees
 - Insurance for pensions and bank deposits
 - Insurance for low probability/high consequence events
 - Public-private partnerships
- The need to replace ageing infrastructure₂

Old Age Dependency Ratios

(Source: United Nations, 2006, World Population Prospects)



Projections of Greying Populations (65+/16-64)



Solutions Are Not Simple

- Some say that there are simple solutions:
 - **Eliminating waste;**
 - **Introducing automatic cuts;**
 - **Increasing taxes on the rich;** and/or
 - **“Growing” out of the problem.**
- But the problems of addressing these challenges are too big for any “simple” solution.
- In addition, most countries have accumulated substantial debt and are currently running substantial deficits.
- And the deficits by themselves will get bigger unless the forces fueling them on the spending side are addressed.
- *Legitimate pressures exist to ensure that the impact of decisions made by current generations are not overburdening, denying future generations the services provided by government today.*

The First Priority is to Restore Economic Growth, But...

- *A major problem* is that higher spending and tax cuts will make big budget deficits even bigger, **without necessarily assessing the long-term fiscal impact.**
- And without an explicit commitment and an explicit plan to make **institutional budget reforms**, the fiscal futures for many countries will be grim even after the economy has exited from the current crises.

Institutional Budget Reforms Can Help

- Link the new stimulus programs to **long-term programmatic reforms using performance information.**
- **Change the fiscal rules** under which countries operate in order to promote fiscal sustainability.
- *Most importantly*, and the focus of this presentation, **incorporate assessments of the long-term consequences** of political actions into budget systems.

Link Stimulus Programs to Long-Term Reforms Using Performance Information

- Link stimulus programs to long-term reforms:
 - Tax cuts should be linked to tax reform;
 - Financial & corporate bailouts should be linked to better regulation & incentives for appropriate risk-taking;
 - Expanded public assistance should be linked to reforms that promote incentives to become better prepared for changes to employment opportunities; etc.
- *Although the speed by which the stimulus proposals are being enacted will make linking them to long-term programmatic reforms difficult, they should not be neglected. Reforms can be decided on and implemented after stimulus programs are enacted.*

Change Fiscal Rules To Promote Fiscal Sustainability

- Deficit-based fiscal rules are inherently pro-cyclical, & efforts to adjust such rules for the cycle are futile.
- Spending-based rules that allow for cyclical changes to revenues & spending for automatic-stabilizer programs are inherently counter-cyclical, & thus promote sustainability.
- Spending rules work in good times too, where deficit-based rules usually don't.

Incorporate Assessments of Long-Term Consequences

- Almost all budget processes are very short sighted.
 - They do not force politicians to consider the long-term consequences of their political decisions.
 - They don't even inform politicians—or the public—of such consequences.
- *But some countries have changed their budget systems to make sure that the long-term consequences of current fiscal actions are assessed.*

Long-Term Fiscal Projections: Definition

- A time period of more than 10 years
 - Medium-term forecasts focus on fiscal stability, but not necessarily on sustainability.
 - A number of countries prepare medium-term fiscal frameworks of 8-10 years: Denmark, Sweden, US.
- Coverage of the entire budget, not just specific budgetary funds
 - A number of countries prepare actuarial projections of pension funds: Australia, Canada, Japan, Korea, Sweden, UK.¹¹

Questions Addressed by the OECD Study

1. How have various nations **reformed their budget systems** & decision-making institutions to help them cope more effectively with the long-term fiscal challenges they face?
2. What evidence is there about **the effectiveness of specific reforms** in managing the political incentives that have led to a projected mismatch between obligations and revenues?
3. To what extent and in what ways **are these experiences relevant** to other nations?

Our Ability to Address These Questions Is Crude

- Few countries have reformed their budget systems to incorporate long-term information, and those that have only made changes relatively recently.
- Long-term budgetary outcomes, and the fiscal measures underlying them, are themselves very long term.
- There is a need to control a vast amount of other, frequently more important, factors.
- *Despite the difficulty, an assessment—even if only a crude one—can help steer policymakers towards those system changes that are likely to be valuable to the improvement of their fiscal futures.*

Focus on the Analytical & Institutional Qualities of the Projections

- Analytical quality:
 - Is there an assessment of sustainability?
 - Are the underlying assumptions disclosed?
- Institutional quality:
 - Is there an assessment of the linkages between projections, decision-making processes, & budget institutions?

Why Make Long-Term Projections

- **Sustainability:** long-term projections are needed to help determine whether current government actions impede fiscal sustainability.
- **Intergenerational efficiency:** failure to address long-term fiscal risks early on may force future governments to adopt policies whose costs to the population living at the time will far exceed those borne by taxpayers today.
- **Intergenerational fairness:** governments may miss an opportunity to consider a structured approach where present policies can facilitate the achievement of long-term fiscal policy outcomes that are both sustainable & fair.
- **Intergenerational effectiveness:** failure to address long-term fiscal risks may weaken the ability of governments to respond to other, less predictable problems.

Dimensions of Fiscal Sustainability

(Source: Allen Schick, “Sustainable Budget Policy—Concepts & Approaches”, OECD Journal on Budgeting, 2006)

- **Solvency**
 - The capacity of governments to finance existing and probable future liabilities/obligations.
- **Growth**
 - The capacity of government to sustain economic growth over an extended period.
- **Fairness**
 - The capacity of government to provide net financial benefits to future generations that are not less than the net benefits provided to current generations.
- **Stable Taxes**
 - The capacity of government to finance future obligations without increasing the tax burden.

Methods of Assessing Fiscal Sustainability

- **Baseline Projections**
 - Projects revenues, expenditures, budget balance, and public debt at the end of a select period, using explicit demographic, economic and policy assumptions.
- **Fiscal Gap Analysis**
 - Estimates the adjustment necessary to ensure that the present value of the primary balance, given the present value of debt, to achieve a specified level of debt at the end of a selected period.
- **Generational Accounting**
 - Estimates the net (positive or negative) tax position (taxes paid minus benefits received) of each age cohort over an extended period.

Most countries use baseline projections & fiscal gap analysis.

Many OECD countries report that they prepare fiscal projections, but some EU countries do this solely for EU reporting & not for domestic practices

Frequency of fiscal projection	How many years do projections cover?				
	21-30	31-40	41-50	51-60	61+
Annually			BEL, FIN, FRA, HUN, POL, POR, SWE, UK	CZE	DEN, USA
Regularly (every 3-5 years)		AUS, NZL	GER, IRE, SWI		
Ad hoc basis	KOR		JAP, NOR		NET

Public Fiscal Future Reports

Country	Title of Report	Source	Time horizon	First Report	Freq.
AUS	Intergenerational Report	Treasury	40	2002	Every 5 yrs
CAN	Working papers	Dept of Finance	40	2000	<i>Ad hoc</i>
DEN	EC Convergence Report	Min of Finance	Until 2050/ infinite	1997	Every 5 yrs
GER	Sustainability of Public Finance	Min of Finance	Until 2050/ infinite	2005	Every 3 yrs
KOR	Vision 2030	Min Planning & Budget	25	2006	<i>Ad hoc</i>
NET	Aging & the Sustainability of Dutch Public Finances	Central Planning Bureau	Until 2100	2000	<i>Ad hoc</i>
NZ	LT Fiscal Position	Treasury	40	1993	Every 4 yrs
NOR	LT Perspective	Min of Finance	50	1993	Every 4 yrs
SWE	Sweden's Economy	Min of Finance	Until 2050/ Infinite	1999	Annually
SWI	LT Sustainability of Public Finances	Fed Dept of Finance	50/ infinite	2008	Every 4 yrs
UK	LT Public Finance Report	Treasury	40/ infinite	1999	Annually
USA	LT Budget Outlook	CBO (Congress)	75	1992	Every 2 yrs
USA	LT Fiscal Outlook	GAO (Audit Institution)	75/ infinite	1992	3 times/yr
USA	LT Budget Outlook	OMB (Executive)	75/ infinite	1971-97	Annually

A Note on Canada & Korea

- The fiscal projections made public in Canada were from staff working papers, & did not represent views of the Department of Finance.
 - However, Canada has made a political commitment over the last 15 years to balance the budget and repay debt, which may well be more important than any process requirements.
- The fiscal projections made public in Korea represent more of a government goal & focus on expenditure projections, not revenues.

Sensitivity analyses of demographic & macro assumptions are common, but comparisons to past projections & sensitivity analyses of micro assumptions are not

Country	Report	Comparison w/ past projections	Sensitivity analysis	
			Demographic & macroeconomic assumptions	Microeconomic (expenditure) assumptions
AUS	2007	●	●	○
CAN	2002	○	○	●
DEN	2008	○	○	○
GER	2008	○	●	○
KOR	2006	n/a	○	○
NET	2006	●	●	○
NZ	2006	○	●	○
NOR	2008	●	●	○
SWE	2008	○	●	●
SWI	2008	n/a	●	○
UK	2008	●	●	○
USA (OMB)	2008	○	●	●
USA (CBO)	2007	○	○	●
USA (GAO)	2008	○	○	●

Most countries discuss health, aged-care, education, & pensions separately, but not non-demographic fiscal costs & risks

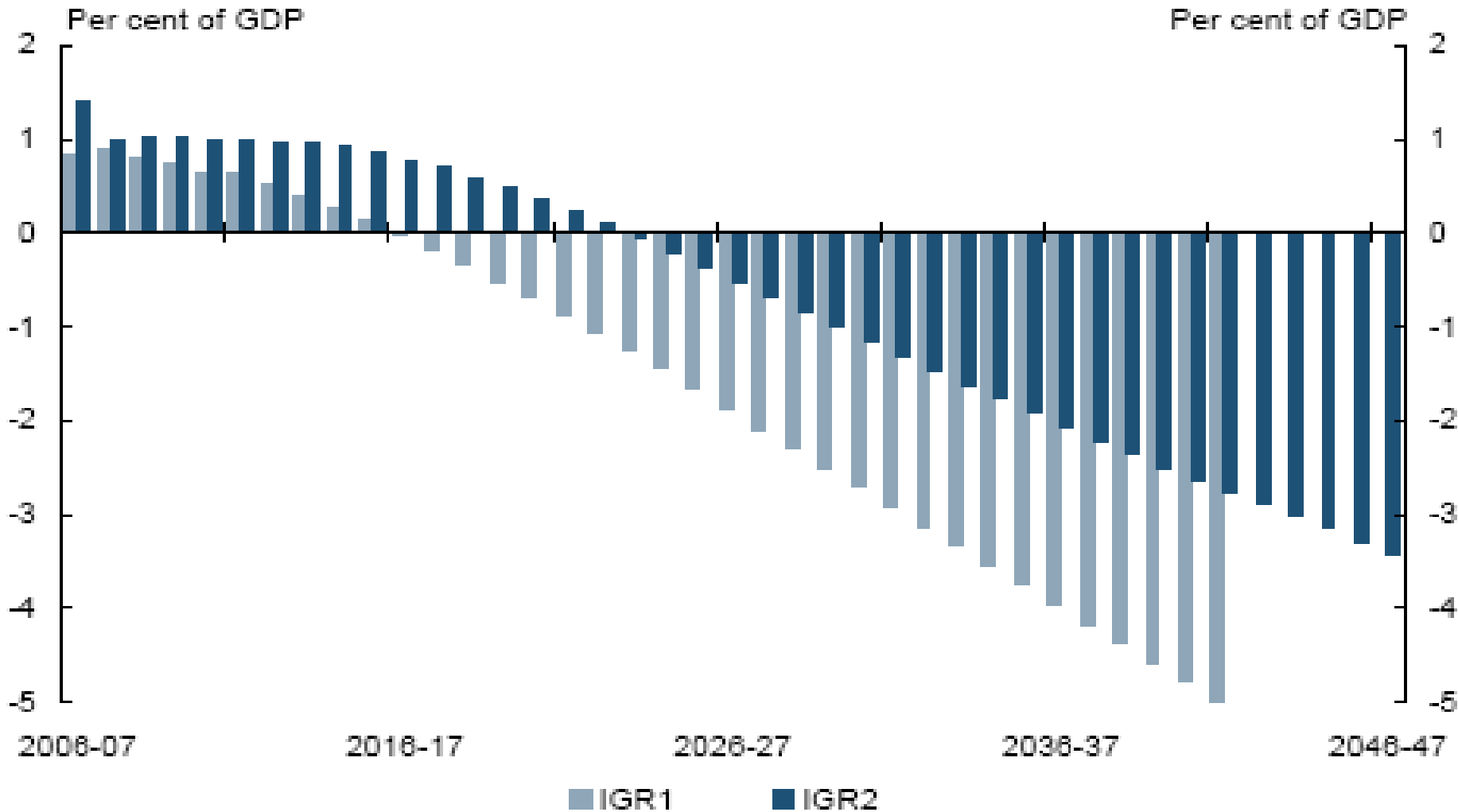
Country	Report	Demographic change			Non-demographic fiscal costs and risks	
		Health & old-age care	Education	Public pensions	Climate change	Contingent liabilities
AUS	2007	●	●	●	●	○
CAN	2002	●	●	●	○	○
DEN	2008	●	●	●	●	○
KOR	2006	○	○	○	○	○
GER	2008	●	●	●	○	○
NET	2006	●	●	●	○	○
NZ	2006	●	●	●	○	○
NOR	2008
SWE	2008	●	●	●	○	○
SWI	2008	●	●	●	○	○
UK	2008	●	●	●	○	○
USA (OMB)	2008	●	○	●	○	○
USA (CBO)	2007	●	○	●	○	○
USA (GAO)	2008	●	○	●	○	○

A Fiscal Future Report: Example I

Australia's Intergenerational Report (IGR)

- Charter of Budget Honesty requires 40-year projections every 5 years, presented to parliament & publicly released
- Projections based on Commonwealth government current policies in “Mid-year Economic and Fiscal Outlook”, adjusted for major policy decisions
- Fiscal indicators used:
 - Government spending per capita
 - Primary balance & net government debt
 - Adjusted primary balance
- Comparisons of government spending per capita & primary balance to previous projection are included
- Sensitivity analysis for demographic & macro assumptions are included as an annex, but not for non-demographic-driven components of different spending categories

Australia's Projections of Primary Balance



Assessing Long-Term Projections: Australia's Operation Sunlight, 2008

- Produce IGR every 3 years with greater disaggregation of expenditure info to programmes level.
- Investigate utility of a whole-of-government triple-bottom line (economic, environment and social) chapter in IGR.
- Make mandatory that all new programmes subject to significant demographic risk be assessed & reported over a 40-year horizon.
- Extend the length of forward estimates presented together with budget from 3 to 6 years for programmes exposed to significant demographic risks.

A Fiscal Future Report: Example II, The Sustainability of Dutch Public Finances

- Fiscal projections of general government until 2100, updated on an ad hoc basis, prepared by the independent CPB, publicly released.
- Current policies based on the most recent budget, factoring in several policy reforms.
- Assumptions:
 - Constant tax rates
 - Spending indexed to either wage or GDP growth
 - Unchanged composition of the economy
- Fiscal indicators include:
 - Projected primary budget balance & debt
 - Sustainability gap
 - Lifetime net tax benefits by population cohort
- Comparison & decomposition to the 2000 projection of the sustainability gap.
- Sensitivity analysis for demographic & economic assumptions on the required primary surplus & sustainability gap.

Potential Dutch Policy Reactions

- Raise indirect taxes or personal income taxes in 2006
- Delay reductions in government material consumption in 2040 rather than 2006
- Abolish tax privileges on pensions
- Raise the statutory retirement age by two years using a one year step in 2015 and 2025.

A Fiscal Future Report: Example III

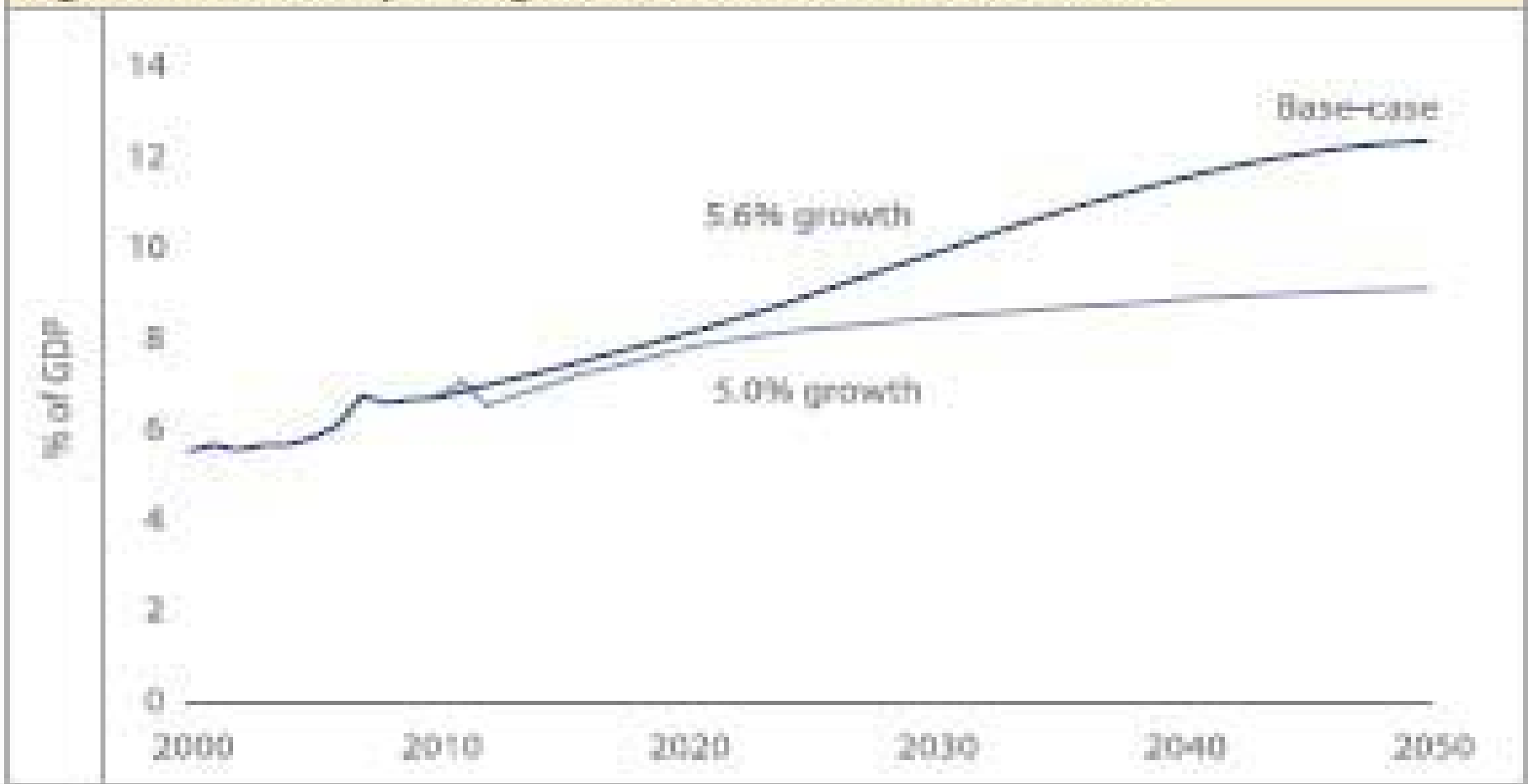
New Zealand's Long-Term Fiscal Position

- Presents bottom-up long-term fiscal projections:
 - Government spending by category
 - Primary operating balance
 - Net debt
- Sensitivity analysis is done only on expenditures, presenting impact on primary balance and debt.
- Presents top-down long-term fiscal projections assuming:
 - Gross debt at 20% of GDP; and,
 - With policy options to slow health spending growth or cap “other” operating expenditures.
- Past/current policy actions not discussed in report.



NZ's Long-Term Fiscal Position, 2006: Necessary Changes to Health Spending to Achieve Gross Debt Target

Figure 11.8: Health spending slowed to limit debt to 20% of GDP



Source: The Treasury

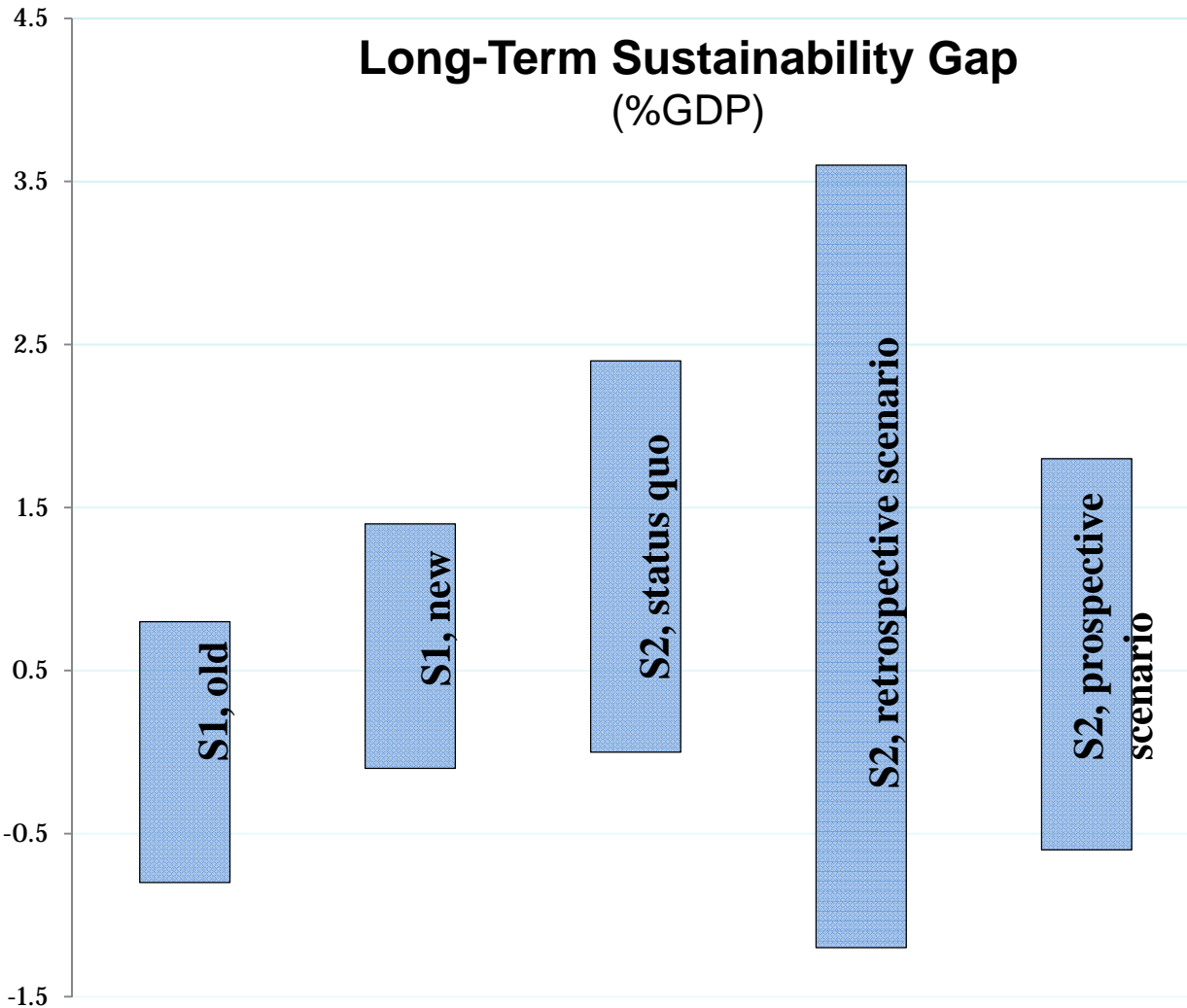
A Fiscal Future Report: Example IV

Germany's

Report on Sustainability of Public Finance

- **Presents bottom-up long-term fiscal projections:**
 - Government spending as % GDP
 - Net debt
 - EU Sustainability Gap assuming: Debt/GDP ratio continuously balanced between 2011-50, & infinitely balanced
- **Not a baseline projection but a range (“corridor”) factoring in sensitivity analysis**
- **Sensitivity analysis for revenue and health spending**
- **Estimated impact of policy simulations for retrospective and prospective changes include**
 - Long-term care insurance
 - Civil service pension reform

Range of Germany's Sustainability Gap Under Different Policy Simulations, 2008



Sustainability gap : the necessary increase in primary net borrowing

- **S1, old**: debt/GDP ratio if budget continuously balanced, 2011-50;
- **S1, new**: debt/GDP ratio reaches 60% GDP by 2050;
- **S2**: Intertemporal budget restriction is met.

S2 policy simulations

- **Status-quo**: includes pension reforms, but not latest changes in long-term care, insurance/civil service pensions
- **Retrospective scenario**: excluding pension reforms of 2004 (sustainability factor) & 2007 (raising the retirement age to 67)
- **Prospective scenario**: **assumes** latest changes in the field of long-term care, insurance/civil service pensions

Some Preliminary Findings

- Detail varies significantly across countries.
- Some countries prepare rolling projections; others updates with the same end-year.
- Some countries present sensitivity analysis of projected fiscal position; others as an annex; & others as alternative policy scenarios.
- Discussions comparing assumptions, changes in methodology & fiscal position with previous reports are done only in Australia & the UK.
- Projections focus on fiscal risks associated with ageing populations, but not on climate change, globalization.
- Germany prepares fiscal futures reports based on independent economic research institute's projections.

Recommendation I: Strengthen Explicit Disclosures

- Incorporate comparisons with past government assessments to highlight trends in sustainability.
- Include sensitivity analysis of demographic, macro- and micro-economic, and other assumptions to illustrate exposure to risks.
- Clearly present changes in the methodology and key assumptions to provide a means of assurance and credibility of their quality.

Recommendation II: Link Projections to Budget

- Prepare them on an annual basis to eliminate discretion over when projections are produced.
- Use them to illustrate the fiscal consequences of reforms or policy options—if not in the report, then when initiatives are proposed.
- Tie them to other budget practices & procedures (fiscal rules & triggers) to build action around assessments of sustainability.

Answers to the Study's Questions

1. How have various nations **reformed their budget systems** and decision-making institutions to help them cope more effectively with the long-term fiscal challenges they face?
 - *See Overview for a summary.*
2. What evidence is there about **the effectiveness of specific reforms** in managing the political incentives that have led to a projected mismatch between obligations and revenues?
 - *Some, but it is too soon to tell, and it is difficult to determine a direct linkage between reforms, incentives, and outcomes.*
3. To what extent and in what ways **are these experiences relevant** to other nations?
 - *There may be important lessons from the experiences of the countries who have tried to use long-term information:*
 - **Some countries have improved their fiscal futures.**
 - **Combining long-term assessments with better use of performance information and changes in fiscal rules, including the use of triggers, may be very valuable.**

Conclusion

The expanding use of fiscal projections in countries with very different governmental and budgetary systems supports that these recommendations should be relevant to a broad range of OECD and non-OECD countries alike.