

# **Design of Budget Systems and Fiscal Outcomes**

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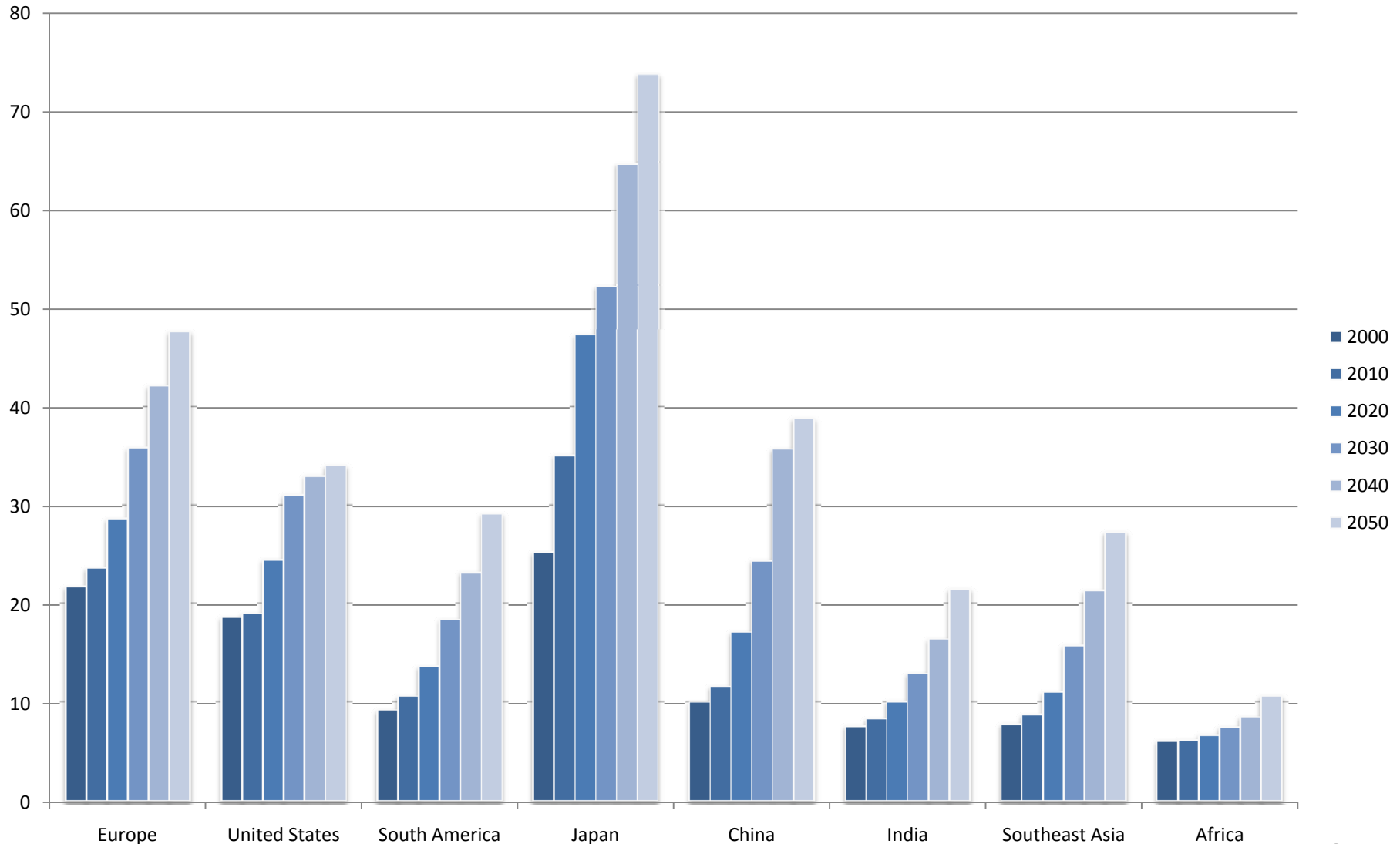
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# Countries Around the World are Facing Long-Term Fiscal Challenges

- 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
  - public-private partnerships
- The need to replace ageing infrastructure

# Old Age Dependency Ratios

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



# Solutions are Not Simple

- Some say that the funding to address these challenges can be found by:
  - **Cutting 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 that are 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.**
- 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.
- **Incorporate assessments of the long-term consequences** of political actions into budget systems.

# Link Stimulus Programs to Long-Term Programmatic Reforms Using Performance Information

- Link stimulus programs to long-term reforms:
  - Tax cuts should be linked to tax reform;
  - Financial and corporate bailouts should be linked to better regulation and 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 very difficult, they should not be neglected. Reforms can be decided on and implemented after the stimulus programs are enacted.*

# Change Fiscal Rules To Promote Fiscal Sustainability

- Deficit-based fiscal rules are inherently pro-cyclical, and efforts to adjust such rules for the cycle are hopeless.
- On the other hand, spending-based rules that allow for cyclical changes to revenues and spending for automatic-stabilizer programs are inherently counter-cyclical, and thus promote sustainability.

# **The *Most Important Quick Reform:* Incorporate Assessments of Long-Term Consequences of Political Actions Into Budget Systems**

- 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 addressed.*

# Questions to be 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 **is this experience relevant** to other nations?

# Our Ability to Address These Questions Will Be Crude

- Few countries have reformed their budget systems to incorporate long-term information, and they have only made these 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.**

# “Review of International Experiences” Report Outline

- Long-term projections—a discussion of why make long-term projections and how to evaluate them
- Fiscal future reports by country, including:
  - Assessments: does the country attempt to make a long-term projection of its fiscal future, and if so how often and what methodology does it use?
  - Actions: does the country take any kind of actions to address its fiscal future? Such actions are frequently in the form of a fiscal rule or other formal budget process provision, but need not be so.
  - Outcomes: has the above had an impact?
- Findings: using the information gathered to address the 3 questions posed above
- Literature review and references

# Why Make Long-Term Projections

- **Sustainability:** long-term projections are needed to help determine whether current government actions impede fiscal sustainability.
- **Transparency:** capital markets need long-term information to be able to anticipate the consequences of the long-term fiscal status.
- **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 by which present policies can facilitate the achievement of long-term fiscal policy outcomes that are both sustainable and fair.
- **Intergenerational effectiveness:** failure to address long-term fiscal risks may weaken the ability of governments to respond to other, less predictable problems.

# Four 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, expenditure, 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.
- **Balance Sheet Accounting**
  - Measures the government's current net wealth in reference to the balance sheet, applying accepted accounting standards.
- **Generational Accounting**
  - Estimates the net (positive or negative) tax position (taxes paid minus benefits received) of each age cohort over an extended period.

**More countries use Baseline Projections.**

# Overview of Fiscal Future Reports

Country	Legal Requirement	Title	Source	Years	Start	Freq.
Aus	Charter of Budget Honesty	Intergenerational Report	Treasury	40	2002	Every 5 yrs
Den		A Sustainable Future	Min of Finance	9	1997	Every 5 yrs
Ger		Rpt on Sustainability of Public Finance	Min of Finance	45	2005	Every 3 yrs
NZL	Public Finance Act	LT Fiscal Position	Treasury	40	1993	Every 4 yrs
Nor		2006 White Paper	Min of Finance	55	2004	Annually
Swe		Sweden's Economy (annex to budget)	Min of Finance	45	1999	Annually
UK	Code of Fiscal Stability	LT Public Finance Report	Treasury	30	1999	Annually
US: CBO		LT Budget Outlook	CBO	75	1991-2000	Every 2 yrs
US: GAO		LT Fiscal Outlook	GAO	75	1992-97	3 times/yr
US: OMB		LT Budget Outlook in Analytical Perspectives	OMB	75	1971-97	Annually
EU	Stability & Convergence Programming Surveillance	Public Finances – EMU	Economic Policy Comm.	55	2005	Annually

# A Special Note on Canada

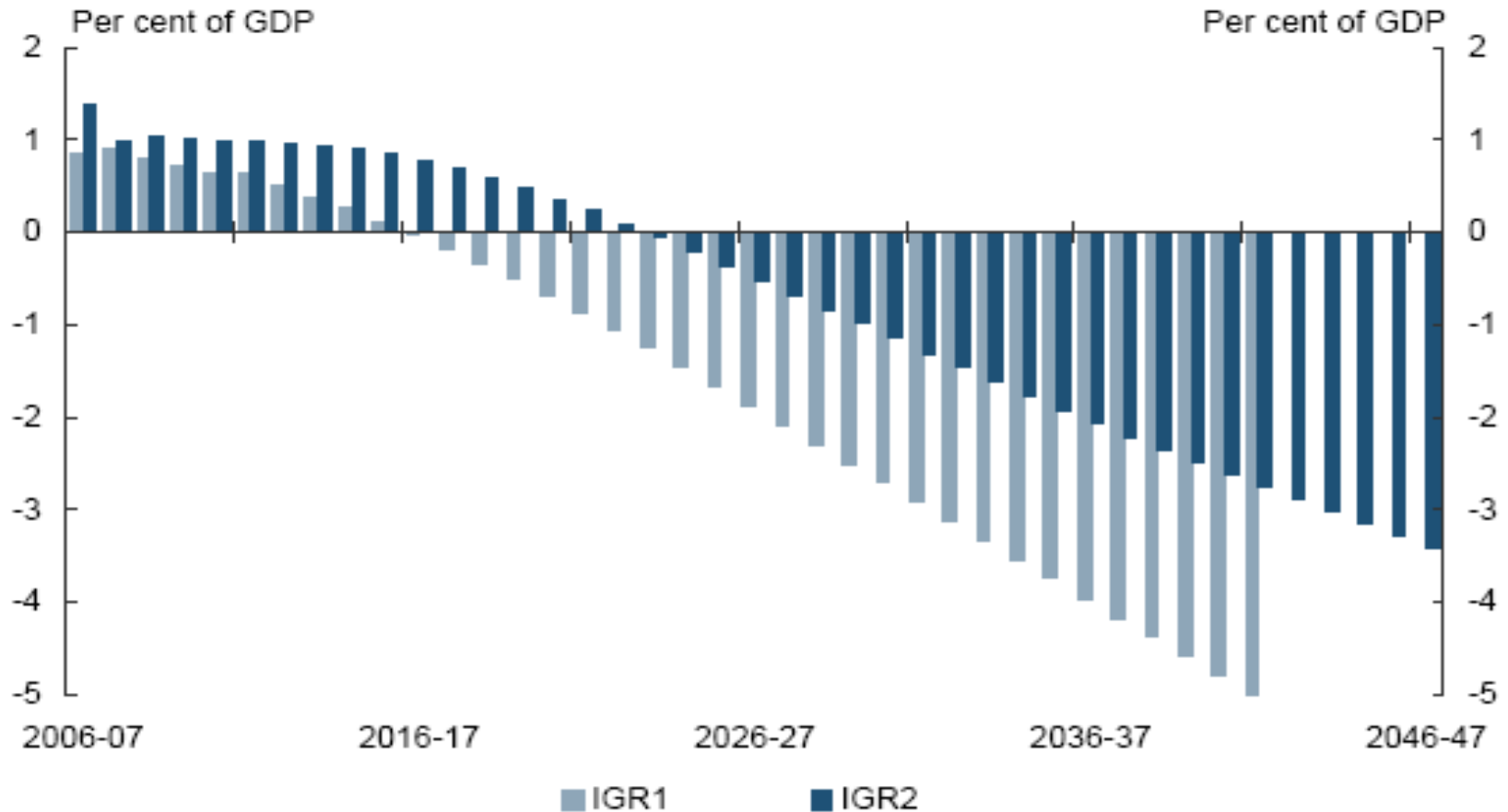
- Although Canada does not prepare long-term fiscal projections in general or as part of the budget process, it has made a political commitment over the last 15 years to maintain a balanced budget.
  - This commitment has obviously helped Canada reduce debt significantly, but has done so without changing its budget process to incorporate long-term fiscal projections.
  - The Department of Finance Canada prepares a number of studies and working papers that examine long-term fiscal projections, but these appear to be altogether separate from the budget process.

# A Fiscal Future Report: Example I

## Australia's Intergenerational Report

- Presents a single bottom-up long-term fiscal projection under current policy assumptions:
  - Government spending categories to GDP
  - Primary balance
  - Net debt
  - Spending and primary balances compared to past projections
- Sensitivity analysis is done only on expenditure categories as annex to report; the impact on primary balance and debt not presented.
- Other past/current policy actions discussed in report
  - Debt: Establishment of Future's Fund
  - Health: Reforms to government pharmaceutical spending
  - Demographics: Welfare to work, income tax cuts

# Australian Intergenerational Report, 2007: Projections of Primary Balance



Note: The projections are of the primary balance (which excludes net interest payments and Future Fund earnings).

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

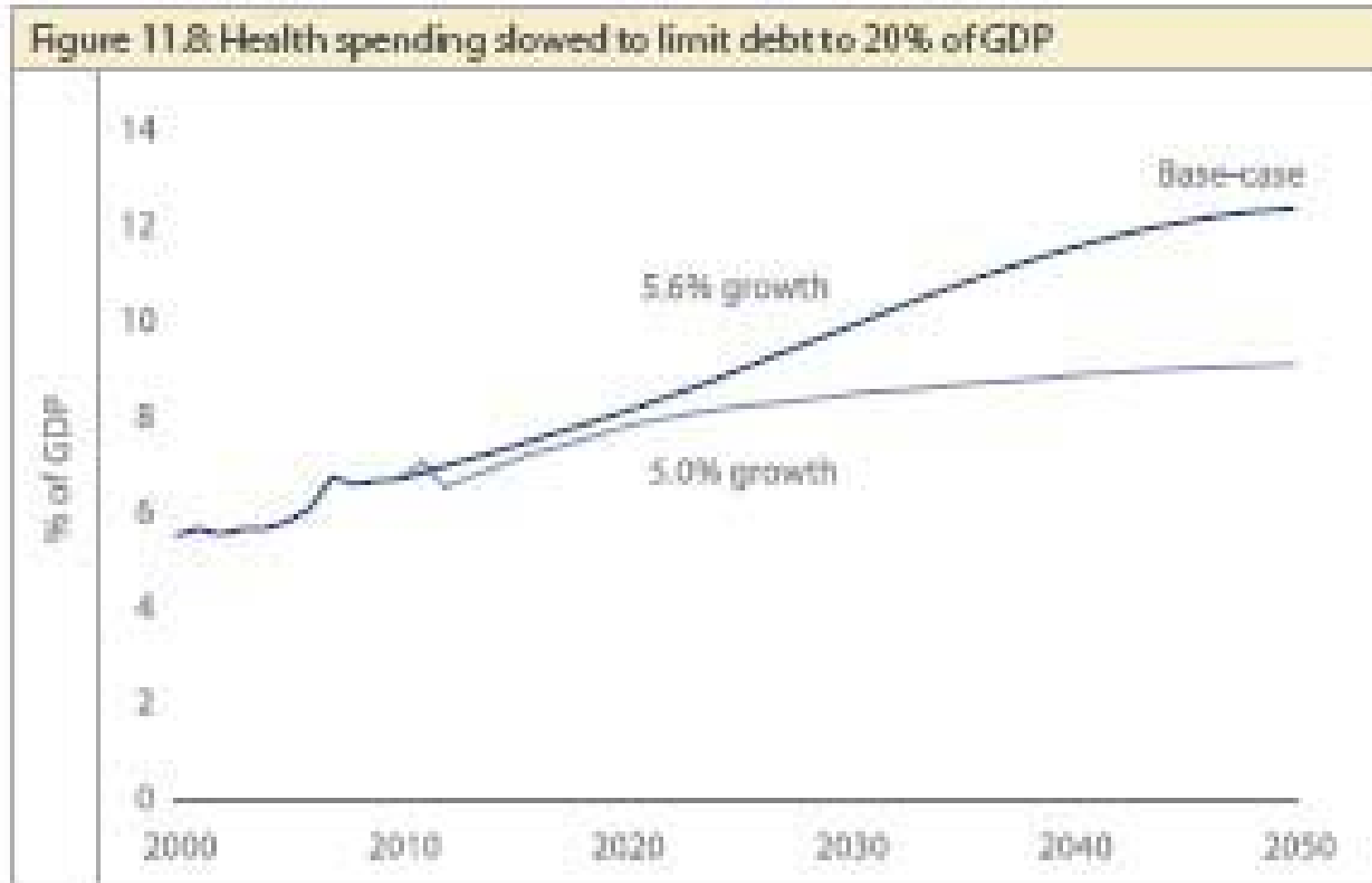
- Commits to build fiscal sustainability & strengthen the role of long-term projections in budgetary decisions:
  - Requires all expenditure measures at risk of long-term growth be subject to mandatory long-term assessment when proposed
  - Makes it mandatory that all new programs subject to significant demographic risk be assessed & reported over 40 year horizon
  - Extends forward estimates period to 6 years for programs likely to be subject to demographic pressures
  - Investigates utility of whole-of-government triple-bottom line (economic, environmental, & social) assessments in Intergenerational Report
  - Shortens frequency of Intergenerational Report to every 3 years (currently 5) w/ greater disaggregation at program level

# A Fiscal Future Report: Example II

## NZ'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



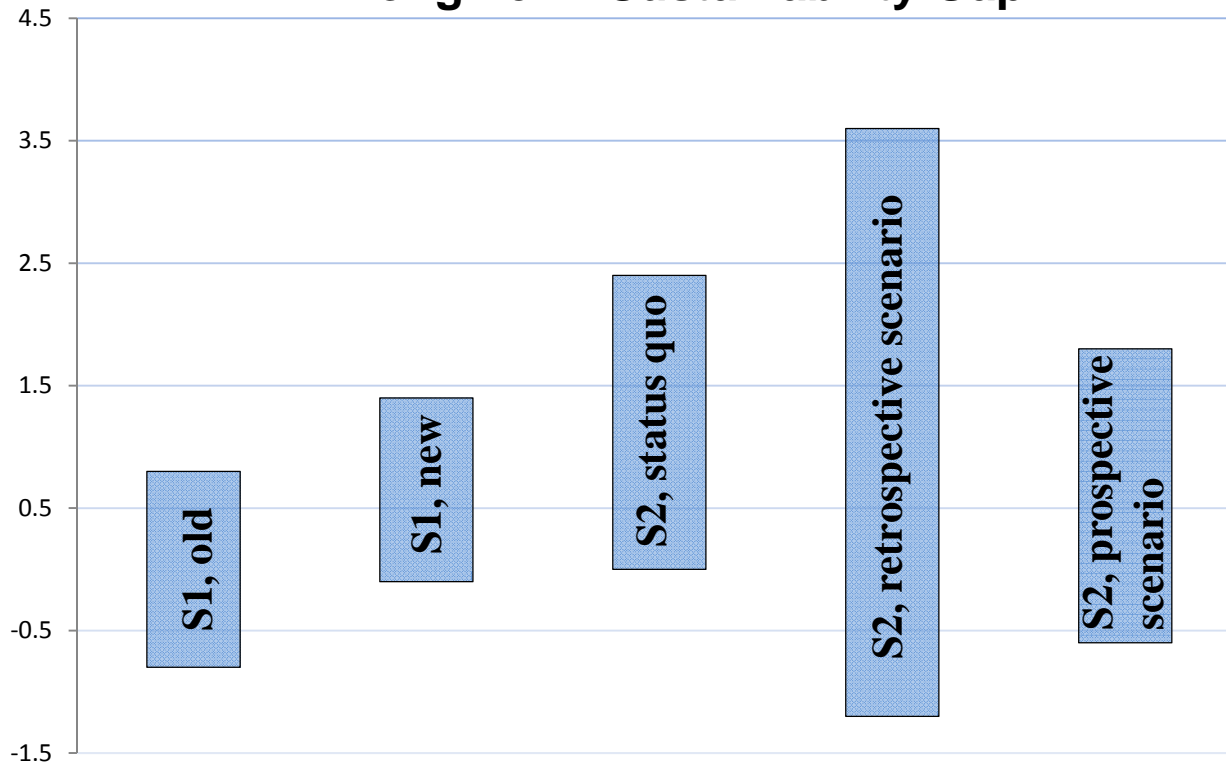
# A Fiscal Future Report: Example III

## 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 both: the 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 included
  - Long-term care insurance
  - Civil service pension reform

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

Long-Term Sustainability Gap



**Note:** German report present simulations of S2 indicator in table format in comparison. The results have been presented in the same table for this power point presentation.

**Sustainability gaps** is the necessary increase in primary net borrowing (% GDP) using different measurement methods.

- **S1, old:** debt/GDP ratio if budget continuously balanced, 2011-2050;
- **S1, new:** debt/GDP ratio reaches 60% GDP by 2050; and
- **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) and 2007 (raising the retirement age to 67)
- **Prospective scenario:** latest changes in the field of long-term care insurance / civil service pensions taken into account.

# Some Preliminary Findings

- The level of detail in the revenue and expenditure projections varies significantly across countries.
  - Australia & NZ provide the most detailed information, including past trends, key drivers, methodology & assumptions; Germany, UK, & US far less.
- Some countries prepare rolling projections (Australia, NZ, UK, USA); others prepare updates with the same end-year (Germany).
- Some countries present sensitivity analysis of projected fiscal position (NZ); others present sensitivity analysis as an annex (Australia); others present alternative policy scenarios (US).
- A discussion comparing the assumptions, changes in methodology & fiscal position between the present report with past reports is done only in Australia & the UK.
- Only the US long-term projections explicitly present debt service.
- Projections focus on fiscal risks associated with ageing populations, but not on climate change, globalisation, etc.
- Germany prepares fiscal futures report on basis of independent economic research institute's projections.

# Possible Answers to the Questions to be Addressed by the Study

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 on p. 16 for a summary of the few countries who have some kind of fiscal future reports.
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?
  - Virtually none: it is far too soon to tell, and there does not appear to be any direct linkage between reforms, incentives, and outcomes.
3. To what extent and in what ways **is this experience relevant** to other nations?
  - There may be important lessons from the experiences of the countries who have tried to use long-term information:
    - **Some of the countries have clearly improved their fiscal futures.**
    - **Although we can't tell how much putting long-term issues on the political agenda really helps, there is no evidence that it hurts.**
    - **Combining long-term assessments with better use of performance information and changes in fiscal rules, including the use of triggers, may be very valuable.**