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Budgeting for Fiscal Space

by
Allen Schick*

Fiscal space refers to the financial resources available to a government for policy initiatives through the budget and related decisions. This article reviews the factors that contribute to the shrinkage of fiscal space, considers methods for protecting or enlarging it, and reflects on how budgeting may be recast into a process for explicitly allocating scarce fiscal space.

* Allen Schick is Distinguished University Professor, University of Maryland, United States. This article was originally published in 2009 as Chapter 16 in the OECD publication *Evolutions in Budgetary Practice* (ISBN 978-92-64-06087-6).

Fiscal space refers to the financial resources available to a government for policy initiatives through the budget and related decisions. The term excludes money allocated in the previous budget and continued in the next, but does include funds that become available through reallocation, incremental resources generated by economic growth, borrowed funds in excess of current revenues, and additional revenue from increases in taxes. Although the term was initially devised for low-income countries, it has useful application in developed countries as well. In developing countries, fiscal space is an estimate of the growth-enhancing investment in physical and human capital that a government can finance with borrowed funds without prejudicing the long-run sustainability of its fiscal position. In this context, fiscal space justifies allowing cash-short governments to borrow for productive expenditures that have a strong prospect of being repaid through the additional revenues produced by an expanding economy.

This paper focuses on the concept of fiscal space for OECD member countries. In this setting, fiscal space pertains to the way governments go about allocating resources. As a process, fiscal space may be regarded as being as old as budgeting itself, or as a fundamentally new way of making budget decisions. It may be regarded as an old concept because budget officials in all countries routinely estimate the "room" available for new expenditures or the "gap" between projected revenues and expenditures. Budget officials typically make these estimates early in each cycle and update them during formulation of the budget. In most countries, the process is largely informal; it is not codified by budget rules. Nevertheless, the practice is ubiquitous because it informs political leaders and budget officials of the amounts that may be spent through new decisions. They need this information to review spending bids and policy initiatives, and to set the budget aggregates.

In a formal sense, however, the concept of fiscal space deviates from the aims of past budget reforms. It recognises that budgeting is inherently incremental and that most decisions focus on marginal adjustments in programmes and expenditures. In compiling budgets, governments rarely treat spending on existing and proposed new programmes in the same way, nor do they ordinarily undertake a comprehensive review of expenditures. As Wildavsky argued almost half a century ago, incremental behaviour enables governments to complete budget work in a timely manner by reducing conflict over resources and by reducing the number of decisions that must be made. After decades of unsuccessfully trying to uproot budgeting's incremental tendencies through bold innovations such as programme budgeting and zero-base budgeting, some governments have begun to formally incorporate incremental norms into the construction of the budget. Two of the most popular contemporary innovations – baseline projections and medium-term expenditure frameworks (MTEF) – build incrementalism into the routines of budgeting. Baseline projections use the current level of expenditure as the starting point for compiling the next budget; an MTEF allocates resources to spending units in terms of changes to the baseline. Fiscal space reinforces these incrementalist reforms by focusing budget work on the new resources available for allocation. If budgeting is unavoidably incremental, the

fiscal space argument runs, it makes sense to formally structure the process so that it deals with the resources for which decisions will be made.

The prospect of a more constrained budget environment in the decades ahead also has spurred interest in fiscal space. Governments are not concerned about fiscal space when there are sufficient resources to finance ongoing problems as well as significant policy initiatives. They do pay attention to fiscal space when the budget is tight and when spending priorities are crowded out by insufficient resources. Population ageing in most OECD countries and a concern that economic growth may be less robust than in the past indicate that fiscal space may shrink or possibly vanish in the years ahead. The loss of fiscal space gives rise to the possibility that budgeting will become a decremental process that allocates losses rather than gains. If this were to occur, budgeting will likely become a more contentious process, and politicians will have difficulty financing policy initiatives.

From this perspective, the budget predicament of high-income countries shares some common traits with the situation that confronts low-income countries. Because resources are scarce and demands are elastic, both groups of countries have incentive to structure budget decisions in terms of the space available for allocation. But not all scarcities are alike. There are observable differences between governments that have incremental funds for programme enhancements and those that lack sufficient resources for existing programmes. For developing countries, fiscal space means the capacity to finance productive investment with borrowed money; for affluent countries, space is the increment available to expand programmes.

This paper deals with developed countries. Hence, the concept of fiscal space presented here is inextricably linked to incrementalism in budgeting. Section 1 reviews the factors that contribute to the shrinkage of fiscal space, including pressure on both the revenue and expenditure sides of the budget. Section 2 considers methods for protecting or enlarging fiscal space through adjustments in spending commitments to free up incremental resources and through changes in the way budgets are prepared and expenditures managed. The concluding section reflects on how budgeting may be recast into a process for explicitly allocating scarce fiscal space.

1. The shrinkage of fiscal space

In all highly developed countries, the national government has vastly more money to spend than it had half a century ago. In almost all, however, the government has narrower budget options than it once had. Spending more but having less to spend undermines incremental behavior and underlies the contemporary interest in fiscal space. The volume of space depends on four variables: the extent to which existing programmes claim incremental resources, the propensity of a government to tax, its propensity to borrow, and the performance of the economy. All four factors may now be less favourable than during the post-war spurt in government spending, which is why budget options appear to be more constrained. Each variable is considered in the paragraphs that follow.

1.1. Public expenditures

Contemporary governments have less to spend because public expenditures are sticky – that is, they do not readily respond to changes in political conditions or national priorities. A decision to spend money one year usually is a decision to spend in future years as well, even where there is no legal requirement to do so. When a government launches a

new programme, it also ignites political and bureaucratic pressure to continue or enlarge that programme. Groups form to protect their interests, administrative entities are established and staffed to run the new programme, and the programme's expenditures are incorporated into the "base" when the room for incremental expenditure in future budgets is estimated. Often, the new programmes are protected against price increases, thereby increasing their claim on future resources.

If expenditures were not sticky, budgeting would not be incremental. A government could treat new and old claims alike, and broaden its discretion to the full amount of expenditure. Stickiness has a positive side, for it stabilises government, gives citizens clear expectations of the services that will be available in the future, and diminishes conflict over resources. It would be a mistake, however, to regard expenditures as perfectly sticky. Much of the political craft of budgeting involves adjustments at the margins. These sometimes entail programme terminations, but they more frequently amount to shifts within programmes. These shifts are often below the "radar" of budgeting; they are implemented unilaterally by spending units and are not brought to the attention of central budget makers. This tactic has the advantage of reducing the risk that shifts might lead to a loss of resources.

Expenditures tend to be sticky even for programmes that do not perform well. In fact, a government may consider it necessary to augment resources when results fall short of expectations. For example, governments frequently supplement the budgets of troubled schools, either in response to parental demands or in the hope that the additional funds would enable them to improve. Of course, expenditures for successful programmes are also sticky, as supporters exploit their performance to extract more money from the government.

The problem for contemporary governments is not only that expenditures are sticky but that they are so very large, much larger as a share of GDP in member countries than they were when the OECD was established nearly half a century ago. Table 1 shows that, although countries differ significantly in the relative size of the public sector, all member countries have experienced a progressive increase in government spending. Several powerful trends account for most of this rise. One is the shift in risk from households to the government; related to this is growth of the entitlement state which has transformed more than half of national expenditure in most OECD countries from discretionary budget decisions into spending mandated by permanent law.

In industrial countries, the government has become the holder of risk for society. The government indemnifies workers for loss of jobs, seniors for retirement, patients for illness, and families for various losses of income. In some countries, citizens and enterprises are compensated for losses due to natural or human-made disasters, farmers are protected against the risk that the market price of commodities will fall, depositors against the risk of default by financial institutions, exporters against changes in currency values, and so on. Some important risks still remain in private hands, but in all advanced countries the public budget is exposed to risks taken by the government.

The pooling of risk through government action has certainly contributed to economic and personal well-being, even though it has sometimes opened the door to moral hazard. A bigger problem is that a government rarely has a reliable estimate of the risk it is taking, nor does it provision for downstream costs in the budget. When these come due, sometimes only years later, the government has no choice but to make good on its obligations.

Many of the biggest risks facing contemporary governments are in the form of entitlements, which give the eligible persons a legal right to payment from the government.

Table 1. **Year-to-year percentage change in real GDP**[1]

Annual average, selected periods 1960-2000

	1960-68	1968-73	1973-79	1979-89	1989-2000
Australia	5.0	5.5	2.6	3.4	3.2
Austria	4.2	5.9	3.0	2.1	2.5
Belgium	4.5	5.6	2.4	2.2	2.2
Canada	5.6	5.6	3.9	2.9	2.5
Denmark	4.6	4.0	1.5	1.4	2.2
Finland	3.9	6.7	2.4	3.6	2.0
France	5.4	5.9	2.8	2.4	1.8
Germany	4.2	4.9	2.4	2.0	1.8
Greece	7.3	8.2	3.3	0.8	2.1
Iceland	4.1	7.6	5.3	3.2	2.5
Ireland	4.2	4.8	4.9	3.1	7.4
Italy	5.7	4.6	3.5	2.4	1.6
Japan	10.5	8.8	3.5	3.8	1.8
Luxembourg	3.1	6.5	1.3	4.3	5.6
Netherlands	4.8	5.3	2.6	2.0	3.0
New Zealand	3.1	5.1	0.0	2.0	2.5
Norway	4.4	4.1	4.6	2.7	3.2
Portugal	6.6	7.4	2.9	3.3	2.9
Spain	7.5	6.8	2.3	2.8	2.7
Sweden	4.4	3.7	1.8	2.2	1.7
Switzerland	4.4	4.5	–0.4	2.1	1.1
Turkey	5.8	5.5	4.5	4.0	4.1
United Kingdom	3.1	3.2	1.5	2.4	2.2
United States	4.5	3.3	3.0	3.0	3.1

1. This table only includes countries that were OECD members throughout the periods covered.

Sources: Data for the periods 1960-68 and 1968-73 are drawn from *OECD Historical Statistics 1960-1983*; data for subsequent periods are drawn from *OECD Historical Statistics 1970-2000*. The two data sets are not consistent; hence the data reported here are not strictly comparable across all periods.

Typically, entitlements are open-ended; they establish a formula for payment, but do not limit a government's exposure. A government must make room for them in the budget when the event or condition triggering the entitlement occurs. Governments can enlarge space in the budget for priorities by curtailing entitlements, but doing so may ignite strong protest. Quite often, bold efforts to trim entitlements end up as marginal adjustments that have little or no effect on near-term budgets, but may create space in distant budgets.

The prognosis in almost all developed economies is that demographic trends will compel national governments to allocate a rising share of their budgets to entitlements established in previous generations. Not only will these expenditures be sticky, but much of the increment available for allocation will also be sticky. The challenge for future governments will be to "unstick" a sufficient portion of expenditure to maintain budgeting as a genuine allocation process.

1.2. The propensity to tax

When space is insufficient to finance programme ambitions and past commitments, governments are tempted to look at the revenue side of the budget. Obviously, spending could not have grown so much during the past half century if governments had relied only on the increments supplied by economic growth. In fact, all governments of OECD countries raised tax rates and expanded the tax base during that expansionary period. They boosted tax revenues in good times because voters wanted enhanced services, and

they boosted them when fiscal space was inadequate because expenditures were sticky. Table 2 compares government revenue as a share of GDP at various points during the past 40 years. With revenue in the OECD area rising from 28% of GDP in 1960 to 37% in 1990, the data suggest that governments had ample space for budgetary initiatives.

Table 2. **Current receipts of government as a percentage of GDP**[1]

Annual average, selected periods 1960-2000

	1960-67	1968-73	1974-79	1980-89	1990-2000
Australia	25.6	27.7	28.7	31.6	32.2
Austria	35.8	40.3	43.1	46.4	47.6
Belgium	30.1	35.2	43.9	46.6	46.8
Canada	27.8	34.8	36.8	39.3	–
Denmark	30.1	42.5	45.2	52.0	54.3
Finland	30.8	35.0	41.7	44.8	50.7
France	37.2	38.8	40.7	45.5	46.5
Germany	36.1	39.5	44.0	45.1	45.3
Greece	23.6	26.7	29.1	32.8	41.8
Iceland	30.3	33.4	35.9	41.4	36.6
Ireland	27.2	33.9	35.9	41.4	36.6
Italy	29.7	30.6	33.5	36.8	43.9
Japan	20.4	20.9	24.6	30.6	30.5
Luxembourg	34.2	36.3	50.1	–	44.9
Netherlands	36.4	35.8	51.0	55.2	47.8
Norway	36.2	45.4	48.4	50.3	51.4
Portugal	19.5	23.0	27.6	35.0	37.7
Spain	18.6	22.5	25.7	34.0	38.0
Sweden	37.5	47.9	54.4	59.4	57.3
Switzerland	23.6	26.6	32.7	34.1	–
United Kingdom	32.6	38.1	38.9	40.9	37.8
United States	27.0	29.8	29.7	31.0	–

1. This table only includes countries that were OECD members throughout the periods covered. New Zealand and Turkey have been excluded because of lack of data.

Sources: Data for the periods 1960-67 and 1968-73 are drawn from *OECD Historical Statistics 1960-1983*; data for subsequent periods are drawn from *OECD Historical Statistics 1970-2000*. The two data sets are not consistent; hence the data reported here are not strictly comparable across all periods.

Table 2 reveals, however, that the rate of expanding budget space through sizeable tax increases has ended in many OECD countries. In a few, revenues have actually declined as a share of GDP, as governments have purposely reduced their fiscal space in a determined effort to shrink the relative size of the public sector. In most countries, revenues have remained stable for an extended period, suggesting that the government faces political resistance to tax increases as well as pressure to maintain existing programmes. Although it is hard to generalise across the OECD area, because member countries have different tax policies, it is reasonable to conclude that most countries now finance policy initiatives through economic increments and cutbacks or efficiency gains in existing programmes. These actions purchase fiscal space for the budget cycle immediately ahead, but do not significantly alter the long-term imbalance between revenues and expenditures.

Tax policy is never fully at rest. Governments endlessly tinker with rates and rules, sometimes to add or subtract revenue, often to adjust the burden on particular sectors or activities. The extent to which future adjustments affect fiscal space will depend on citizen sentiment and political preferences. In some countries, voters will prefer to hold on to

promised benefits or to expand governmental responsibilities, even when doing so compels higher taxes. In others, future fiscal space will be constricted by strong resistance to any increase in the tax burden. Countries with relatively high levels of taxation may face conflicting pressures. On the one hand, the high tax rates may indicate political support for a large government role; on the other hand, high tax rates may establish a ceiling on the capacity to generate additional revenue. Countries with an elevated dependency ratio due to ageing populations will likely be pressured to boost taxes. They may find it more expedient to spread the cost among consumers and income earners than to impose benefit cuts on those already receiving payments from the government or scheduled to do so in the next ten years or so.

Budgeting is a process of marginal adjustment to enlarge short-term space. On the tax side, there are numerous opportunities, such as raising "sin" taxes and making small adjustments in other revenue sources. Countries with relatively high levels of tax expenditures may consider it expedient to enlarge budget space by curtailing these subsidies. Governments may also ease budget pressures by relying more heavily than in the past on non-tax income such as fees for public services. In the long run, however, the impact of revenue policy on fiscal space will depend on two key variables: the propensity of governments to make big rather than small adjustments in tax burdens, and the performance of the economy. The worst scenario for future budget makers is one in which the economy stagnates and political leaders lack the will to generate additional revenue; the most favourable scenario is the reverse. Though unlikely, it would enable the governments of OECD countries to recreate the golden age of expansion.

1.3. Deficit budgeting

Fiscal space can be enlarged by adding borrowed funds to the resources produced by current revenues. In fact, many OECD countries borrowed heavily during the post-war growth spurt to finance investment as well as current expenditure. Evidently, the surge in revenue did not fully cover burgeoning public expenditures. Governments had a propensity to borrow because of a far-reaching shift in fiscal doctrine from the balanced budget norm to active demand management. As has often been noted, the governments of OECD countries came to regard balancing the economy as more salient than balancing the budget. The accumulation of public debt was considered prudent because governments would repay their obligations out of the dividends of economic growth.

In those halcyon years, fiscal space was rarely a problem, though governments routinely were pressured by steeply rising demands. When the economy was buoyant, a government acquired ample space from the surge of revenue into its coffers. When the economy weakened, the government created space by justifying deficits that would narrow the gap between potential and actual output. Two factors converged in the late 20th century to undermine the case for deficit financing. One was the looming demographic tide that would impose enormous budget costs on future governments; the other was a shift away from flexible fiscal policies to fixed targets that constrain budget deficits. Most of the early targets were political statements that lacked enforcement and were frequently ignored. Nevertheless, the targets were useful political messages; they signaled to spenders that the high-growth era was drawing to a close and that future budgets would be constrained.

Accommodating targets have been replaced in many OECD countries by preset rules, such as the Stability and Growth Pact (SGP) which limits the annual budget deficit and public debt of euro-zone countries to a fixed per cent of GDP and authorises the European Commission to sanction countries that breach the limits. The original SGP was rigid: its

limits allowed no exceptions, regardless of economic circumstances or demands on the budget. Whatever its virtues, rigidity impaired a government's capacity to adopt stimulative budget policies during cyclical weakness in the economy. Moreover, the limits blocked counter-cyclical adjustments through the budget's built-in stabilisers. In 2005, the EC revised the SGP to allow some flexibility when warranted by economic conditions. Arguably, the changes have vitiated the rules but, in this writer's view, the appropriate test of their effectiveness is whether they constrain fiscal outcomes, not whether they absolutely bind politicians. To the extent that they have narrowed the fiscal space available for budget allocation, the rules have had a pronounced impact.

Outside the European Union, countries generally have taken a more flexible path that relies on political accountability rather than imposed limits to strengthen fiscal discipline. This fiscal responsibility approach requires a government to establish multi-year targets for selected aggregates (such as the primary balance or public debt as a share of GDP), to update the targets periodically and explain changes to them, and to report fiscal outcomes. This self-enforcing rule aims to make political leaders accountable for fiscal results, but it does not bar them from running up deficits. In contrast to fixed rules which are most constrictive when the economy is weak, the fiscal responsibility concept constrains the budget when the economy is strong and deficits are receding or have disappeared. When the economy is faltering, a government can fulfil its fiscal responsibilities by explaining why it has eased the constraints. The penalty for fiscal irresponsibility is that voters will turn the government out of office.

Fine-tuning fiscal rules so that they distinguish between different economic conditions is exceedingly difficult. One approach, which was popular during the growth era but subsequently fell into disuse, is to separate out the portion of deficit due to economic weakness while requiring that the budget be structurally balanced. Structural rules were abandoned because they were difficult to enforce and may have contributed to the upward creep in public expenditure, tax burdens and public debt. It appears that there is no perfect time for enforcing fiscal rules. When the economy is robust, a government has plenty of money to distribute via tax cuts and spending increases; when the economy is weak, the government must spend more than it has.

Although they may have limited effectiveness, fiscal rules do shrink budget space. Whether in the form of fixed limits or fiscal responsibility procedures, the rules bespeak a more constrained budget environment, a sense of constraint and a need for government to be more prudent. Inasmuch as the effects of fiscal rules depend on political will, the fact that government leaders are less willing to spend in excess of revenue reduces the space available for allocation. Table 3 confirms this conclusion, for it shows lower net borrowings by OECD countries during the past decade.

1.4. Economic performance

The final element in assessing fiscal space is the performance of the economy. High growth rewards a government with incremental revenues which (due to tax elasticities) generally rise faster than GDP. Of course, the reverse holds when the economy weakens, leaving a government with a shortfall in revenue. Expenditures also fluctuate with shifts in economic conditions, though not to the same extent as revenues. With revenues and expenditures moving in opposite directions, the budget has automatic stabilisers which enlarge fiscal space in good times and shrink it in bad times.

Table 3. **Net lending of government as a percentage of GDP**[1]

Annual average, selected periods 1960-2000

	1960-67	1968-73	1974-79	1980-89	1990-2000
Australia	1.4	1.9	–3.4	–3.3	–2.2
Austria	0.6	0.8	–2.0	–3.2	–3.0
Belgium	–	–	–5.8	–10.7	–4.2
Canada	–0.7	0.9	–2.0	–4.8	–
Denmark	1.5	2.9	0.5	–2.1	–0.6
Finland	2.3	4.1	5.0	3.6	–1.2
France	0.5	0.6	–0.9	–2.3	–3.5
Germany	0.8	0.2	–3.0	–2.1	–2.9
Iceland	2.9	0.9	–8.4	–9.4	–
Ireland	–3.4	–3.6	–9.2	–11.0	–0.5
Italy	–1.8	–4.8	–9.2	–11.0	–6.9
Japan	–	1.0	–3.4	–1.5	–3.5
Luxembourg	2.4	1.7	2.9	–	3.0
Netherlands	–0.7	–0.3	–2.0	–5.1	–2.6
Norway	4.0	4.3	2.5	5.2	3.8
Portugal	–0.2	1.5	–5.3	–5.5	–3.9
Spain	–	0.4	–0.7	–4.4	–4.0
Sweden	3.3	4.4	1.3	–1.6	–2.9
United Kingdom	–1.1	–0.4	–3.9	–2.3	–3.1
United States	–0.5	–0.6	–1.5	–3.4	–

1. This table only includes countries that were OECD members throughout the periods covered. Greece, New Zealand, Switzerland and Turkey have been excluded because of lack of data.

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Budgeting is a temperamental process. When the economy is strong, budget makers tend to allocate resources in the expectation that favourable conditions will continue. The opposite tendency prevails when the economy is weak. To the extent that economic performance has trended downward in recent decades, it has diminished the amount of space that governments have allocated. Table 4 displays economic growth trends for OECD countries; it shows that, while all countries experienced cyclical variations in performance, growth spurts have been weaker than in the past.

In forming expectations about the future, potential performance carries more weight than predictions about how the economy will actually perform. An economy's potential rests on two main variables: the size of the workforce and its productivity. In most OECD countries, future workforce growth will be significantly lower in the decades ahead as their populations age and older workers retire. Most of the gain in output will have to come from rising productivity, which is extremely difficult to predict. It is highly probable that productivity gains will be uneven over an extended period and that GDP growth also will be uneven. Fiscal space will expand and shrink in response to economic developments, and budget policy will adjust to swings in performance. It is not feasible to predict exactly how the economy will perform in the future, but demographic trends will make it difficult for OECD countries to match past results.

Table 4. **Current disbursements of government as a percentage of GDP**[1]

Annual average, selected periods 1960-2000

	1960-67	1968-73	1974-79	1980-89	1990-2000
Australia	20.4	22.1	30.2	33.8	31.7
Austria	29.3	33.4	40.0	46.2	48.1
Belgium	39.1	33.9	46.6	54.9	50.3
Canada	25.8	31.6	36.9	42.6	–
Denmark	25.1	35.0	43.2	54.2	55.6
Finland	24.3	27.5	33.8	39.0	50.9
France	33.0	34.8	38.9	45.8	48.2
Germany	30.2	34.1	42.2	43.8	44.2
Greece	19.7	22.4	28.0	39.2	46.1
Iceland	21.3	24.1	25.6	29.5	–
Ireland	26.7	32.8	40.0	47.4	35.6
Italy	11.1	13.0	38.7	44.3	48.7
Japan	13.7	14.6	21.7	26.3	28.4
Luxembourg	28.7	30.6	41.3	–	38.7
Netherlands	32.3	41.1	49.1	56.3	49.0
Norway	29.0	37.2	42.1	42.8	45.5
Portugal	17.5	19.1	29.1	36.5	39.1
Spain	14.5	19.0	23.6	34.3	38.8
Sweden	29.6	38.5	49.5	59.2	59.0
Switzerland	19.0	22.0	29.2	30.3	–
United Kingdom	30.8	33.4	39.8	42.0	39.6
United States	26.3	29.7	30.7	33.9	–

1. This table only includes countries that were OECD members throughout the periods covered. New Zealand and Turkey have been excluded because of lack of data.

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2. Protecting and enlarging fiscal space

Fiscal space is a variable quantity that is enlarged or decreased by government action. As discussed in the previous section, past expenditure decisions greatly narrowed the options open to future budget allocators. The task facing contemporary budget officials is to expand fiscal space so that expenditures reflect the policies and preferences of the government.

An essential step is to guard against revenue or spending actions which have only modest impact in the year(s) immediately ahead but balloon in future years. When the current budget is tight, politicians may be tempted to structure revenue losses and expenditure increases in ways that claim little space in the current budget but pre-commit future space without regard for downstream demands on the budget. Many costly entitlements have this characteristic, especially when payments are deferred to later years as is often the case in government-financed retirement benefits. Many types of programmes can be designed to shift fiscal impacts beyond the time horizon of the budget process. Future space can be consumed by deferring necessary maintenance on government facilities, launching numerous projects but extending completion over a period of years, awarding public employees small pay increases in the current year and much bigger ones each of the next several years, booking fees for issuing government guarantees as current revenue but ignoring the claims that will arise in case of default, and other bookkeeping tricks.

Even when they do not shift costs to future budgets, politicians act in ways that reduce future space. Whenever an ongoing programme is established, it reduces the room for

manœuvre in future budgets. Several instruments are available for protecting space, ranging from procedures that inform policy makers of downstream consequences to procedures that limit current actions. Baseline projections of the future costs of current policies merely inform budget makers, but when linked to medium-term expenditure frameworks, they limit spending decisions to the amounts that can be accommodated within each year's framework. A variant on this approach is to require that any expenditure increase or revenue loss due to new budget decisions must be offset by spending cuts or revenue increases.

New procedures have been introduced or proposed to protect future space. One is to apply the accrual basis to liabilities that come due beyond the year(s) for which budget decisions are made; another is to account for the estimated present value of future revenue or spending changes as a cost in the current budget. Accruals and present-value estimates can be incorporated into fiscal rules which limit the gap between revenues and expenditures. For example, if a policy change was estimated to add 100 million to the present value of future expenditures, that amount would be expensed in the budget and included in enforcing limits on the deficit. It would be feasible for a government to implement this procedure without shifting the entire budget to the accrual basis. However, enforcing this rule would compel the government to extend its fiscal horizon well beyond the 3-5 years of a medium-term expenditure framework. This issue is taken up in the final section, which discusses changes to the budget process.

2.1. Enlarging fiscal space

Governments that encounter shrinking or inadequate room for policy initiatives have introduced numerous reforms to expand their opportunity for manœuvre. Reforms that have sought to depose incremental norms have always failed, for reasons mentioned earlier in this paper. Accordingly, the adjustments considered here focus on marginal changes in revenue and expenditure policy that would expand the increments available for allocation.

Assuming that increases in tax rates are off the table, the most appropriate course for a government might be to review and prune tax subsidies that diminish its revenues. This option should be the most attractive for countries which forgo significant amounts of revenue through tax expenditures, but these might well be countries in which beneficiaries of tax subsidies are the most effectively mobilised to protect their interests. Nevertheless, it is worth the effort, not only to generate additional revenue, but also to curtail distortions in economic activity caused by undue provision of tax expenditures. In the trade-off between more tax breaks or higher tax breaks, national governments with insufficient budget space would do better by curbing subsidies than by raising already-high rates in order to finance burgeoning expenditure commitments.

On the expenditure side, the most obvious option for enlarging space – reallocation from less to more effective programmes – usually is exceedingly difficult. Every national government has experienced occasional bouts of reallocation: terminating or curtailing major programmes and shifting the funds to other issues. But these bouts are episodic, provoked by fiscal crisis or by major changes in political sentiment and leadership. These reflections are not formally built into the routines of budgeting but are driven by the opportunities of the moment. Quite frequently, however, proposed reallocations fail because they provoke opposition from multiple sources: programme beneficiaries threatened with loss of services, agencies which do not want to surrender coveted activities, politicians discomfited by the prospect of angering voters, public employee unions determined to protect jobs. Explicit reallocation is difficult, even when it is based on evaluative findings and other evidence.

Budgeting is incremental because major reallocations are rare. At the margins, however, there are frequent shifts of resources as new opportunities emerge and old ones recede. These shifts generally are not explicit – they do not overtly pit programmes against one another in a competition for scarce funds. Nor do these shifts take money away from spending units. Instead, they are implicit, and savings are retained by the affected agency. Sometimes these adjustments are made unilaterally by the agency and not even brought to the attention of the central budget office; at other times, the adjustments are agreed in formal budget negotiations. They may be initiated by the spending agency under conditions that significantly lower the risk of losing resources. One objective of the medium-term expenditure framework is to encourage ongoing reallocation and to broaden its scope. But this aim has often been thwarted by faulty implementation of MTEFs.

Four reallocation tactics warrant brief mention. One is to increase budgeted levels by less than the expected rate of inflation. In this situation, programmes and agencies get nominal allocations at the previous year's level or a bit higher, but not enough to compensate for price changes. Recourse to this ploy has been impeded in recent decades by indexation of various programmes and by adjustment of baseline projections for estimated price changes. This issue shall be further discussed in the concluding section below.

Second, marginal reallocations can be financed by reducing agency operating budgets by an amount equal to expected or average gains in productivity or efficiency. These adjustments, which typically range between 1-2% of operating expenditure, are subtracted from either the agency's base budget or from baseline projections. Programme expenditure and transfer payments are exempt from these enforced cuts. Although the amounts saved are small and often are below actual efficiency gains, they stir considerable resentment and can be difficult for small agencies which have little flexibility in managing their budgets.

Third, some governments have experimented with "sunset" rules which automatically terminate programmes or subject them to review according to a fixed schedule, such as every five or ten years. The idea is to require an explicit decision by the government to continue each programme. In practice, sunset provisions have modest impact on minor programmes which have little visibility or political support, but rarely affect the fortunes of large programmes.

Finally, governments can resort to across-the-board cuts to open space for new budget allocations. Singapore, which imposes a 5% cut, puts the savings in a common pool which is allocated through annual budget decisions. This form of cutback is used from time to time by budget officials to close a projected gap between revenues and expenditures. The new version is deployed to make money available for allocation. Consequently, agencies can win back some of the enforced savings by bidding for additional resources.

2.2. Shifting risks and costs

The space created by the various ploys discussed here reinforces incremental tendencies. The ploys do not significantly alter the government's fiscal position. Far-reaching efforts under way in some countries would create budget space by shifting either risk or expenditures from the public treasury to private hands. It was noted earlier that the modern state has become the holder of significant risks for society. Recently, there have been some efforts to reverse this trend through a variety of approaches that offload risk. The most prominent initiative involves retirement benefits which increase in cost as the number of pensioners rises. Traditional defined-benefit plans place the full risk on the government: it must pay promised benefits regardless of the financial condition of its

social insurance funds or the longevity of eligible recipients. By converting all or a portion of payments to defined-contribution schemes, governments shift a sizeable fraction of the risk to recipients. Some governments have gone further and introduced private retirement accounts, usually with a guaranteed minimum payout. A few have adopted a scheme devised by Sweden which adjusts payments at retirement for changes in life expectancy. These types of risk-shifting moves are likely to accelerate in the decades ahead as governments are burdened by the costs of supporting an ageing population.

The best way to avoid risk is to be cautious in taking it on. Because a risk taken one year usually comes due in later years, it can be regarded as costless. It would be prudent for governments to wall off decisions on whether to accept risk from an assessment of potential exposure. Ideally, the assessment should be carried out by an independent office or a central agency, not by the entity tendering guarantees or other risks. Governments can induce a more cautious posture by provisioning for risks in advance or by sharing risks with other parties. A rarely tried mechanism would be for a government to purchase reinsurance when it takes actions that expose it to potential losses. It also can purchase insurance for destabilising events, such as natural disasters which burden national budgets by depressing GDP and public revenues and by compelling the government to pay for reconstruction, even when it does not have a legal obligation. But such insurance may be viewed as a bad deal by politicians because the premiums eat into current budget space.

Governments can shift costs by privatising activities or by financing them privately. Public-private partnerships (PPPs), typically for major construction projects, have become a popular arrangement for shifting upfront construction costs or operating expenses to private entities. In exchange for hiving off these costs, governments may guarantee operating performance. For a road construction project, a government may guarantee a minimum volume of traffic or toll revenue, with the government compensating private investors for shortfalls. In this arrangement, the government reduces near-term expenditure but adds medium- to long-term risk. If PPPs are not diligently crafted with prudent assessment of risks and carefully drafted contracts, a government may gain budget space but undermine the control of future budgets.

Some governments have gone beyond PPPs to sell existing assets and book the income as current revenue. This tactic is open to governments that operate on a cash basis; they can disregard the unpleasant facts that the income is non-recurring and that the increase in budget space is ephemeral. A government determined to invent space by liquefying assets can create novel financing instruments, such as securitising future streams of revenue. This imprudent tactic, which has the same effect as pre-spending future budget space, is never appropriate, even when the government is short of revenue to maintain existing services.

Two different conclusions can be drawn from the foregoing discussion. If the objective is to produce increments for budget allocation, a government has an array of marginal adjustments that give it more fiscal space. If, however, the aim is to transform budget choices, few OECD countries have the political resources to vastly expand fiscal space through fundamental changes in revenue or spending policy. As demographic pressures intensify, more governments may feel compelled to question established revenue and spending policy.

3. Adjusting budget processes

The conduct of budgeting affects the space available for allocation. This concluding section considers how the process might be adjusted to protect and enlarge space. Key

adjustments pertain to the role of the budget office, the time frame of budgeting, the construction of baseline estimates, and incentives for marginal reallocations.

The primary role of the central budget office should be as guardian and allocator of fiscal space. Performing these tasks requires that it have the macroeconomic and programme analytic skills to estimate available space and the impact of proposed or adopted policy changes. The budget office would manage the baseline, extend its data and decisions to future years, provide incentive for spending units to propose and implement policy changes, inject evaluative and performance evidence into budget work, and seek opportunities to expand the space available for allocation. Budgeting, in short, would be the key process for identifying, deciding and financing policy innovation. To be positioned for these tasks, the central budget office would have to abandon some traditional responsibilities, especially the close monitoring and control of expenditures. If it does not offload control functions, the budget office will lack the time, skills, disposition and credibility to manage policy change.

Many central budget offices in OECD countries have already transitioned from control to costing and reviewing policy initiatives. For some, the changeover has been difficult because they no longer are certain of how they fit into the overall financial management framework of government. Modern budget offices realise that it is not viable to intervene in the details of expenditure, but are unsure of which tasks they should perform and which should be devolved to spending agencies. For example, they may be ambivalent about whether programme evaluation and performance measurement – two useful inputs into the policy process – should be led centrally or by line agencies. They may also be anxious about the leverage which is surrendered when they let go of the instruments of control. Having surrendered some powers but not having yet consolidated new ones, the budget office may be a weak counterpart to spending units which have superior access to information and closer ties to sectoral interests.

To facilitate the transition from traditional responsibilities to new roles and relationships, it would be useful for the central budget office to regard fiscal space as its space – that is, as the portion of the budget on which it focuses. From this vantage point, the budget office has an obvious incentive to expand the space by encouraging trade-offs, expanding available increments, setting aside money in bidding funds or other pools, and taking other steps discussed in the previous section. It also has incentive to protect future space by assuring that trade-offs and savings are accurately costed. This assignment can be a challenging one because spenders have incentive to overstate expenditure reductions and underestimate increases when they propose reallocations. To deter these machinations, the budget office must have relevant data and analyses that enable it to review and correct agency misestimates. Even more important, it must have political support at the top of government to confront agencies. When budget trade-offs are collegially decided by cabinet, the budget office may be overwhelmed by log-rolling ministers for whom spending initiatives have higher priority than protecting future fiscal space.

The budget office's role in protecting fiscal space also is undermined when governments make *ad hoc* spending decisions throughout the year. Nowadays, politicians make *de facto* budget decisions when they meet at international forums, interact with interest groups, respond to a crisis or media attacks, and (in some countries) just about every time cabinet meets. In this writer's observation, *ad hoc* budgeting has become much more prevalent than a generation ago, probably due to heightened mobilisation of political interests, greater pressure on governments to deal with unfolding events, stronger transnational

networks, and more openness and transparency in budgeting and other government activities. In a few countries, year-round budgeting has been energised by abundant surpluses which are whittled down by *ad hoc* spending decisions. In some countries, more spending decisions are taken during the period between budgets than during budget season. In several countries, sectoral ministers have "sold" the prime minister costly programme initiatives immediately before the scheduled cabinet meeting, and the proposals were approved without much discussion and without being vetted through the budget process. Whatever the rationale, this practice puts fiscal space at risk by significantly weakening the capacity of the budget office to assess future spending impacts.

3.1. Baseline estimates

To allocate fiscal space, the budget office needs two essential types of information: the volume of available space for the next year or longer; and the extent to which that space would be claimed by proposed or adopted changes in revenue and spending policies. Medium-term (or longer) projections of current policy have become standard budget practice in many countries, particularly those that have introduced MTEF-type arrangements. In contrast to traditional "base" estimates which use the previous year's spending level as the starting point for budget work, baseline projections adjust the base for estimated future changes in prices, workload, and other economic or programme conditions.

In baseline budgeting, fiscal space is the difference between projected revenue and expenditure, plus or minus targeted surpluses or deficits. Policy changes are the estimated changes to these projections due to revenue or spending initiatives of the government. For example, suppose that a government estimates that baseline surpluses will be 100 million next year. It then legislates changes in revenue laws that are estimated to reduce the projected surplus to 80 million. In this case, the policy change consumes 20 million of the available space. Re-estimates due to changes in economic conditions or other technical considerations (such as updated estimates of the number of persons receiving payments under existing law) generally are excluded from the computation of policy changes.

It is important to note that national governments differ significantly in how they construct baseline projections and estimate policy changes. Some governments incorporate estimated price changes in the baseline; others do not. Some include only permanent or structural changes in measuring the impact of policy changes on fiscal space; others include all adjustments. The rules for projecting the baseline have a significant impact on both the volume of space and the estimates of policy change, as shown by the hypothetical comparison in Table 5.

Table 5. **Comparison of baseline projections**

	Baseline revenue	Current expenditure	Estimated price changes	Projected space
Country A	120	100	10	10
Country B	120	100	No adjustment	20

In this illustration, the country that does not incorporate estimated price changes in the baseline has twice as much fiscal space to allocate than the country which includes price changes. In making budget allocations, country B can opt to compensate spending agencies for expected price changes or it can allocate the money for other purposes. Suppose the government decides to spend 105, which would compensate agencies for half of the

projected price increase in this hypothetical case. Country A's decision would be measured as an expenditure cut; country B's decision would be measured as an expenditure increase. Even though the actual expenditure would be identical for both countries, political perceptions would differ greatly. Because of this, country B would likely have far greater difficulty protecting and allocating fiscal space than country A.

There are powerful arguments for and against building estimated price changes into the baseline but, regardless of one's point of view, it should be recognised that baselines are not neutral instruments. How they are prepared directly affects the perceived volume of budget space.

Constructing the baseline and measuring the policy changes are two critical roles of the modern budget office. That office establishes rules for the baseline, updates the projections periodically to incorporate new economic and technical estimates, and measures the budget impact of proposed or approved changes in revenue and expenditure policies. Estimating policy changes is exceedingly difficult for revenue legislation and mandatory entitlements because budget experts must consider how taxpayers and programme beneficiaries will respond to the changes. To make matters even more critical, estimated impacts matter when budget allocations are made, not the actual impacts which only become known after the budget has been decided. In baseline budgeting, erroneous estimates are more relevant in allocating space than what actually ensues in the future.

Because of this, the budget office faces conflicting pressures. From a professional point of view, it must base estimates on specific programme knowledge, an understanding of possible behavioural responses, interactions among programmes and between the policy changes and projected economic conditions, and other variables. From a political perspective, the budget office may feel pressured to produce accommodating estimates that enable policy initiatives to proceed. Ideally, the budget office would deal with these pressures and with the inherent difficulty of projecting an uncertain future by producing a range of estimates. In practice, however, the process of allocating budget space demands that a government have point estimates of the impact of policy changes on revenues and expenditures. Although these estimates are often wrong, sometimes by large amounts, they are the stuff out of which innovative governments allocate budget space.

3.2. Time frames

It makes little sense to allocate fiscal space solely in the context of a single fiscal year. Doing so would give politicians and other claimants the opportunity to veil the true impact of revenue and spending decisions by manipulating the timing of policy changes. In one-year-at-a-time budgeting, programme expansions or revenue reductions scheduled to take effect in a subsequent year would have zero impact on fiscal space. When a government looks only one year ahead, it almost certainly will take actions that deprive it of adequate space in future budgets.

There is yet another reason for extending the time frame: fiscal space tends to be relatively narrow in the year immediately ahead and to widen in subsequent years as the economy grows and revenues become more plentiful. Therefore, a government has greater room for manœuvre when it considers a stream of years rather than only one. When the reverse occurs and the space narrows (or disappears) in future years, the government has a powerful signal that current policies need to be re-examined.

Governments would not be able to expand their fiscal horizon if they lack contemporary budget tools such as baseline projections, socioeconomic models, policy analyses and trend data. The central budget office uses these tools to measure and allocate fiscal space, but other participants in the process use them as well. In contrast to traditional "number crunching" in which the budget office had a monopoly or comparative advantage, it has no special claim of expertise in policy analysis. Anyone with a model or data can estimate the impact of policy changes on future budgets. But although anyone can contribute data and analysis to the policy debate, at the end of the day there can only be one authoritative measure of fiscal impacts, and it is usually the one from the budget office or another central organ.

In advanced countries, budgeting for fiscal space is proceeding along two time frames: the medium term, typically for the next 3-5 years; and the long run, stretching 30 years into the future. The medium term is used for allocation, the long term for analysis of fiscal sustainability. The period of 3-5 years for allocative decisions through an MTEF or similar arrangement recognises the shortness of political terms and the variability of economic conditions. Although it may be desirable to have a longer frame, it may be imprudent to give politicians a platform for pre-spending space too far into the future.

Long-term projections are not used for allocation; rather they analyse whether existing policies are sustainable and equitable across generations. Sustainability focuses on whether extending the revenue and expenditure regime into the distant future will create negative space – that is, a shortfall in resources that would either compel far-reaching policy changes or risk insolvency. Equity focuses on whether future generations will be disadvantaged, compared to the current generation, by a loss in benefits or a rise in tax burdens. It would be desirable to feed long-term projections into ongoing budget work, though one may question whether the budget office should have the main responsibility. Governments that budget exclusively on the cash basis may deem it appropriate to assign long-term work to specialised staff who assess the fiscal position in terms of liabilities rather than disbursements.

3.3. Medium-term expenditure frameworks

The MTEF is at once among the most popular contemporary innovations and among the most misapplied. In blueprint, it is a splendid process for allocating space through policy changes that are costed and decided in compiling the budget. In practice, it often is separated from budgeting and is used to campaign for future spending increases.

The MTEF has two basic features that are relevant to budgeting for fiscal space. First, it has a preset constraint on total spending and (typically) on sectoral or ministerial spending as well. To set the constraint, it is first necessary to estimate the space that will be available for allocation during the next medium-term cycle. Once this space is determined, the constraint is the portion of space that the government intends to allocate. Second, each ministry or sector submits bids for resources consistent with the sub-constraint allocated to it. Any savings proposed by the ministry or sector free up an equivalent amount of resources for allocation. Acting on behalf of the government and, in some countries, with its concurrence, the finance ministry sets the constraint and reviews spending bids to assess whether they are accurately costed and consistent with government policy.

The MTEF accommodates a variety of scenarios with respect to budget space. The standard arrangement may be labeled "positive" space in that the aggregate constraint and sub-constraints have room for expenditure increases. On the other hand, a government

may allocate "negative" space, which would be the volume of savings that would have to be achieved in rolling the MTEF forward. When a ministry is allocated positive space, it may enlarge the resources available for policy initiatives by proposing reductions to existing programmes. These arrangements would not be feasible without baseline estimates and central capacity to estimate the budget impacts of savings and initiatives over the medium term. Moreover, the constraints and sub-constraints must be firm; except for compelling reasons, they should not be modified during preparation of the MTEF. Ideally, proposed reallocation should be based on performance indicators, programme evaluations or other evidence of effectiveness.

It is not hard to understand why the MTEF has been a popular innovation. It extends the time frame of budgeting, declutters the process of less significant detail, focuses on the allocation of fiscal and policy changes, and gives spenders some incentive to propose reallocations. More often than not, however, the MTEF is misapplied, with the unintended result that it may put fiscal space at risk. The major deficiency in implementing an MTEF is that it is treated as a separate activity, not as the core process of budgeting. In some countries, the MTEF has its own staff, a separate database, and distinct procedures for compiling out-year estimates. When a government pretends to have two processes for allocation, only one of them totally matters and it almost always is the annual budget process, not the MTEF.

An improperly implemented MTEF can jeopardise future fiscal space. To understand why, it is necessary to note that an MTEF entails spending decisions for each of the next 3-5 years. These decisions are reflected in the aggregate and sectoral constraints discussed earlier. Each year, when a new budget cycle is launched, the MTEF is rolled forward and the decisions made the previous year are incorporated into new baseline estimates. The previous decisions become constraints on how much can be spent in the years covered by a new MTEF. Revisions to these constraints are budgeted as adjustments to the baseline. A government has the option to keep to the baseline or to authorise policy changes that add to or subtract from expenditure. When the MTEF is separated from the budget, the constraints tend to be soft and, rather than being viewed as ceilings on future spending, they are regarded as floors that enable spending units to campaign for higher allocations in the future. Rather than being an instrument that protects fiscal space, the MTEF is transformed into a process that puts space at risk. The only way to avoid this fact is to have hard constraints that are built into the budget and are not regarded as separate projections.

In a medium-term expenditure framework, the central budget office becomes guardian of the country's fiscal space and manager of the policy change process. This is a more political role than the customary one of reviewing estimates. It sometimes places the budget office on a collision course with political leaders and other central actors. If it cannot perform this role effectively, the government may end up budgeting for fiscal space that it does not have.

Reference

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