Restoring Fiscal Sustainability in Central and Eastern Europe: The Role of Budget Institutions

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Outline

I. Setting the Scene

II. Importance of Budget Institutions

III. Role of Fiscal Responsibility Legislation
I. Setting the Scene
Fiscal Situation in 2010

- Although outlook more favorable than among advanced economies....
- ....projected improvements is barely half of that projected in 2009
- CESEEs expected to run primary deficits over medium term.....
- ...while risks persist, such as:
  - Recovery weaker than expected, leading to possible higher interest rates and lower growth
  - Guarantees and other contingent liabilities more likely to materialize
- All fiscal indicators worse than pre-crisis levels even by end of forecast period
Evolution of Fiscal Balances, 2006–15
(In percent of GDP)

Advanced Economies

Emerging Economies

North Eastern Europe 1/

South Eastern Europe 1/

Source: August 2010 WEO.

1/ Includes Belarus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Russia, and Ukraine.

1/ Includes Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Moldova, Montenegro, Romania, Serbia.
Financing Requirements in 2010 and Deviations from Past Averages
(In percent of GDP)

Includes:
- Bosnia and Herzegovina (BIH)
- Bulgaria (BGR)
- Croatia (HRV)
- Estonia (EST)
- Hungary (HUN)
- Latvia (LVA)
- Lithuania (LTU)
- Macedonia (MKD)
- Poland (POL)
- Romania (ROM)
- Russia (RUS)
- Serbia (SRB)
- Ukraine (UKR)

Note: The size of the bubble reflects the relative size of each country’s debt-to-GDP ratio in 2007.

Source: August 2010 WEO.
(In percent of GDP)

Includes:
Albania (ALB)
Bosnia and Herzegovina (BIH)
Bulgaria (BGR)
Croatia (HRV)
Macedonia (MKD)
Moldova (MDA)
Montenegro (MNE)
Romania (ROM)
Serbia (SRB)

Source: August 2010 WEO.

(In percent of GDP)

Includes:
- Belarus (BLR)
- Czech Republic (CZE)
- Estonia (EST)
- Hungary (HUN)
- Latvia (LVA)
- Lithuania (LTU)
- Poland (POL)
- Russia (RUS)
- Ukraine (UKR)

Source: August 2010 WEO.
II. Importance of Budget Institutions
Why Emphasis on Budget Institutions

- Work carried out by FAD staff on G20 countries, but could be extended to other countries
- Link between budget institutions and fiscal outcomes
- While not a *panacea*, certainly a factor
- Focus on comprehensive frameworks rather than on *single bullet* solution
- Such frameworks may include new institutional arrangements, legislation, procedural and numericla rules all aimed at overcoming deficit bias
Stylized Phases of Fiscal Policy-Making

a. Understanding the Fiscal Position

b. Medium-term Fiscal Planning

c. Implementing through the Budget Process
10 Key Institutions

a. Understanding the Fiscal Position

1. Fiscal Reporting
2. Macro-Fiscal Forecasting
3. Fiscal Risk Management

b. Medium-term Fiscal Planning

4. Fiscal Objectives
5. Medium-term Budget Framework
6. Independent Fiscal Agency
7. Performance Orientation

c. Implementing through the Budget Process

8. Top-Down Budgeting
9. Parliamentary Approval
10. Budget Execution
Fiscal Reporting, Forecasting, and Risk

- Fiscal Reporting
  - Comprehensive and timely financial statements and statistics

- Fiscal Forecasting
  - Range of macro-fiscal scenarios
  - Separate impact of current and new policy

- Fiscal Risk
  - Comprehensive, quantified fiscal risk statement
Medium-term Budget Frameworks: Objectives

- Instill greater fiscal discipline (Finance Ministries)

- Facilitate more strategic prioritization of expenditure (Presidents, Prime Ministers and Planning Ministers)

- Encourage more efficient inter-temporal planning (Line Ministries)
Medium-term Budget Frameworks: Common features

- Early political commitment to expenditure ceiling(s)
  - Coalition Agreement (NL, Finland)
  - Parliamentary Vote (Sweden, France)
  - Government White Paper (UK)

- Ceilings broken down by ministry (not just economic category)

- Estimates reflect full costing of all tax and spending policies

- Ceilings becomes budgets in the absence of agreed
  - Forecast changes
  - New policies

- Margins built into multi-year forecasts to deal with the above
## Medium-Term Budget Frameworks
### Examples

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>COVERAGE</th>
<th>LEVEL OF DETAIL</th>
<th>TIME HORIZON</th>
<th>DISCIPLINE</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Soc Sec</td>
<td>% of Public Sending</td>
<td>Total Spending</td>
<td>Rolling or Fixed</td>
</tr>
<tr>
<td></td>
<td>Debt Interest</td>
<td>Local Gov’t</td>
<td>3</td>
<td>2 fixed + 1 rolling</td>
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<tr>
<td></td>
<td>Local Gov’t</td>
<td>4 Sectors</td>
<td>4</td>
<td>4 fixed</td>
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<tr>
<td></td>
<td>% of Public Sending</td>
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<td>3</td>
<td>2 fixed + 1 rolling</td>
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<tr>
<td></td>
<td>Total Spending</td>
<td>4</td>
<td>4 fixed</td>
<td>Every 4 years</td>
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<tr>
<td></td>
<td>Local Gov’t</td>
<td>4 fixed</td>
<td>Every 4 years</td>
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<td>Local Gov’t</td>
<td>Every year</td>
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### FIXED MINISTERIAL PLANS

<table>
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<tr>
<td></td>
<td>Soc Sec</td>
<td>% of Public Sending</td>
<td>25 Depts</td>
<td>3 fixed</td>
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<td></td>
<td>Debt Interest</td>
<td>Local Gov’t</td>
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<td>2 fixed + 1 rolling</td>
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<tr>
<td></td>
<td>Local Gov’t</td>
<td>35 Missions</td>
<td>3</td>
<td>Rolling</td>
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<tr>
<td></td>
<td>Local Gov’t</td>
<td>20 Depts 267 Progs</td>
<td>3</td>
<td>Rolling</td>
</tr>
<tr>
<td></td>
<td>% of Public Sending</td>
<td>Total Spending</td>
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<td>Rolling</td>
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<td>Every year</td>
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<td></td>
<td>Local Gov’t</td>
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### ROLLING PROGRAM ESTIMATES

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Medium-Term Objectives and Rules

- The effectiveness of numerical rules—mechanisms for placing durable constraints on fiscal discretion through numerical limits on budgetary aggregates—depends on a number of desirable institutional requirements.

- Timing and design also essential for effectiveness.

- The introduction of rules may be inappropriate:
  - in the absence of preconditions, as may lead to a loss of credibility;
  - rules that are desirable for the long run would not fit the short run fiscal policy requirements.

- But at times the adoption of fiscal rules may generate beneficial dynamics that can help accelerate reforms aimed at developing those prerequisites.

- Fiscal rules may be warranted to guide policy, particularly when the deficit bias persists due to common pool problems.
## Fiscal Objectives/Targets/Rules

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Rationale</th>
<th>Good Practice</th>
<th>Bad Practice</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Medium-term horizon</strong></td>
<td>• Separate fiscal policy and budget decisions</td>
<td>• Over the cycle (UK)</td>
<td>• Annual deficit ceiling</td>
</tr>
<tr>
<td></td>
<td>• Flexibility to deal with volatility or shocks</td>
<td>• Over the Parliament (NL)</td>
<td>• Debt reduction path</td>
</tr>
<tr>
<td><strong>Comprehensive in scope</strong></td>
<td>• Limit scope for burden shifting</td>
<td>• General Gov’t (SGP)</td>
<td>• Budget</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Public sector (UK, NZ)</td>
<td>• Central Gov’t</td>
</tr>
<tr>
<td><strong>Binding on outturn</strong></td>
<td>• Reduce optimism bias in forecasts</td>
<td>• “Debt brake” rule (Swiss)</td>
<td>• Aim for balance over the forecast horizon</td>
</tr>
<tr>
<td></td>
<td>• Ensure deviations are made up in future</td>
<td>• Maintain debt below 40% of GDP (UK)</td>
<td>• Real expenditure growth targets</td>
</tr>
<tr>
<td><strong>Stable over time</strong></td>
<td>• Build public support</td>
<td>• Procedural FRLs (Aus, NZ)</td>
<td>• Frequent revision to numerical rules</td>
</tr>
<tr>
<td></td>
<td>• Raise reputational cost of breaking the rule</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Precise &amp; transparent</strong></td>
<td>• Provide clear guide for policy-making</td>
<td>• 1% surplus over the cycle (Sweden)</td>
<td>• Increase net worth over time</td>
</tr>
<tr>
<td></td>
<td>• Facilitate evaluation of compliance</td>
<td></td>
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</tr>
</tbody>
</table>
# Independent Fiscal Agencies

<table>
<thead>
<tr>
<th>Country</th>
<th>Institution</th>
<th>EX ANTE</th>
<th>EX POST</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>Parliamentary Budget Office</td>
<td>Validate Macro Assumptions: Yes</td>
<td>Scrutinize Fiscal Policy: Yes</td>
</tr>
<tr>
<td>UK</td>
<td>Office of Budget Responsibility</td>
<td>Responsible for economic and fiscal forecast used in Budgets and Pre-Budget Reports</td>
<td>Assesses whether Gov’t has &gt;50% probability of meeting fiscal objectives</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Central Planning Bureau</td>
<td>Full economic forecast</td>
<td>Costs election platforms &amp; Coalition Agreement</td>
</tr>
<tr>
<td>Sweden</td>
<td>Fiscal Policy Council</td>
<td>Evaluates transparency &amp; credibility of Gov’t forecasts</td>
<td>Assesses sustainability of fiscal policy</td>
</tr>
<tr>
<td>Hungary</td>
<td>Fiscal Council</td>
<td>Full economic forecast, Baseline fiscal projections, Budget impact of legislation, Methodological recommendations</td>
<td>Advises Gov’t/Parl. on Fiscal policy, Transparency, Accounting</td>
</tr>
</tbody>
</table>
Performance Orientation

- Program-based classification and appropriation of expenditure

- Non-financial performance targets associated with each program with regular reporting of progress

- Periodic expenditure reviews to assess program performance
Top-Down Budgeting

**Cabinet**
- Cabinet endorses aggregate/ministerial budget ceilings at start
- Line ministry budget requests must be within ceilings
- Planning margin within ceiling to fund new policies

**Parliament**
- Pre-Budget orientation debate focused on MT fiscal strategy
- Annual budget voted in two-stage sequence:
  - Total expenditure
  - Individual allocations
- Any increase in total expenditure during execution requires supplementary budget
Budget Execution Controls

a. Commitment Controls
- **Top**: Political commitments
- **Middle**: Delegated limits
- **Bottom**: Legal commitments

c. Adjustment Mechanisms
- Access to reserves
- Carry-over/use of windfalls
- Virement rules

d. Accountability Mechanisms
- Separation of baseline and policy changes
- Budget to budget reconciliation
- Accounting Officers

CORE CAPABILITIES

- **i.** Alignment of fiscal rule to budget controls
- **ii.** Forecasting and analytic capacity in MoF
- **iii.** Timely & reliable budget execution data
- **iv.** Delegation of responsibility to line ministries

b. Prioritization Mechanisms
- **AUS**: Exp Review Cttee
- **FIN/NL**: Coal. Agreements
- **UK**: Spending Reviews
- **France**: RGPP

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Flexibility

Accountability

Discipline

Legitimacy
Conclusions

- Considerable variations across and within G20:
  - Fiscal reporting and budget execution areas of relative strength, but breadth of coverage, understanding of future implications less developed and assessment of fiscal risk still limited
  - Medium-term budget frameworks and independent evaluation relatively underdeveloped because of limited coverage and not so binding constraints
  - Performance information not yet fully integrated in budget decision
  - Top-down procedures increasingly popular but not binding because of earmarking, standing commitments, and extra budgetary activities and decisions
III. Fiscal Responsibility Legislation
What is a Fiscal Responsibility Law?

- A “Fiscal Responsibility Law” is a limited-scope law with organic or “standing” status that elaborates on the rules and procedures relating to three budget principles: *accountability*, *transparency* and *stability*.

- In other words, a law (or part of a law) which aims to improve fiscal discipline by requiring governments to declare and commit to a monitoreable fiscal policy strategy.
Four Key Characteristics

- Specification of the medium-term path of fiscal aggregates.
- Description of the medium-term and annual budget strategy for attaining the chosen fiscal objectives.
- Regular publication of reports (at least twice a year) on the attainment of fiscal objectives or targets.
- Audited annual financial statements that assure the integrity of fiscal information.
Issues

- FRLs, much like numerical fiscal rules, increasingly seen as single solution to fiscal policy problems.
- New wave of FRLs tends to be *omnibus* as an attempt to buy credibility and restore fiscal solvency and/or sustainability.
- As result, overly complex and ambitious, often difficult to implement as weaknesses in public financial management systems remain unaddressed.
## Systemic problems in fiscal policy-making

<table>
<thead>
<tr>
<th>Problem</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Time-inconsistency</td>
<td>Policymakers’ ex ante intentions differ from their ex post incentives</td>
</tr>
<tr>
<td>b. Short-sightedness</td>
<td>Policymakers discount long-term consequences of current policies</td>
</tr>
<tr>
<td>c. Collective action</td>
<td>Policymakers favor sectional over collective interests</td>
</tr>
<tr>
<td>d. Information asymmetry</td>
<td>Policymakers hide consequences of their policies from the public</td>
</tr>
<tr>
<td>e. Principal - agent</td>
<td>Policymakers and budget agents have different incentives</td>
</tr>
<tr>
<td>f. Exogenous shocks</td>
<td>Sound policies are blown off course by unexpected events</td>
</tr>
</tbody>
</table>
How FRLs Can Respond to These Problems

<table>
<thead>
<tr>
<th>Problem</th>
<th>FRL Features</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Time-inconsistency</td>
<td>a. Fiscal Rules</td>
</tr>
<tr>
<td>b. Short-sightedness</td>
<td>b. Medium-term Budget Frameworks</td>
</tr>
<tr>
<td>c. Collective action</td>
<td>c. Top-Down Budgeting</td>
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<tr>
<td>d. Information asymmetry</td>
<td>d. Transparency</td>
</tr>
<tr>
<td>e. Principal-agent</td>
<td>e. Sanctions</td>
</tr>
<tr>
<td>f. Exogenous shocks</td>
<td>f. Escape Clauses</td>
</tr>
</tbody>
</table>
Key Choices in FRL Design

### FRL Features

- **a. Fiscal Rules**
- **b. Medium-term Budget Frameworks**
- **c. Top-Down Budgeting**
- **d. Transparency**
- **e. Sanctions**
- **f. Escape Clauses**

### Design Choices

- Procedural rules
- Numerical rules
- Fixed ceilings
- Rolling estimates
- Cabinet discussion
- Parliamentary approval
- Financial reporting
- Fiscal councils
- Administrative
- Financial
- Criminal
- Trigger mechanism
- Transitional arrangements
# Examples of Procedural Rules

<table>
<thead>
<tr>
<th>Country</th>
<th>Fiscal Principles</th>
<th>Statement Contents</th>
<th>Sample Rules/Objectives</th>
</tr>
</thead>
</table>
| **Australia**                     | • Keep debt at prudent levels  
• Adequate national savings  
• Moderate cyclical fluctuations  
• Ensure stable tax system  
• Regard to future generations | • LT fiscal objectives  
• ST fiscal targets  
• Budget priorities  
• Stabilization measures  
• Accounting basis | • Balance on avg over cycle  
• Surpluses over forecast period  
• No increase in tax burden from 1996-7 levels  
• Improve net worth over M-LT |
| **New Zealand**                   | • Keep debt at prudent levels  
• Balance operating budget over reasonable period  
• Maintain adequate net worth  
• Prudently manage fiscal risks  
• Ensure stable tax system | • LT fiscal objectives  
• ST fiscal intentions  
• S & LT fiscal projections  
• Assessment of consistency w/ principles | • Operating surplus on ave over cycle  
• Keep net debt below 40% of GDP & reduce to 30% by early 2020s & 20% over the LT  
• Net worth rising by early 2020s |
| **United Kingdom**                | • Transparency  
• Stability  
• Responsibility  
• Fairness  
• Efficiency | • LT fiscal objectives  
• Fiscal rules for Parliament  
• ST econ & fiscal outlook  
• LT fiscal projections  
• Analysis of cyclical impact | • Golden Rule: Balance the current budget over the cycle  
• Sustainable Investment Rule: Keep debt below 40% of GDP |
Transparency: Fiscal Reporting

EX ANTE
- Macroeconomic assumptions
- Budget plans
- Policy costs
- Fiscal risks
- Forecast methodology

EX POST
- Deviations from fiscal targets due to
  - Macroeconomy
  - Revenue
  - Expenditure
- Reasons for deviations broken down into:
  - Forecast changes
  - Policy changes
  - Accounting changes
- Compliance w/ fiscal rules

All in a multi-year perspective
Sanctions: Reputational, Administrative or Criminal

- Parliamentary systems (Aus, NZ, UK) tend to rely on transparency and reputational sanctions.

- Federal systems (Arg, Brazil, Spain, Peru) rely more on administrative sanctions. Include:
  - Submission of adjustment plan
  - Reductions in federal transfers
  - Limits on sub-national borrowing/guarantees
  - Wage and hiring freezes
  - Federal take-over or merger with other local authority

- Personal or criminal sanctions are rare and rarely applied (Brazil, Ecuador)
Conclusions

- Why so few advanced countries have adopted a FRL—only two have in place a narrowly-defined FRL?

- Advanced countries generally have well-established legal frameworks for public financial management.

- Constitution provides for objectives of FRLs or requires a high-level (“organic”) public finance law for budget system.

- Fiscal stability objectives can be achieved by arrangements other than by the adoption of a dedicated FRL.

- The experience of embedding numerical fiscal rules in FRL-type legislation has been disappointing.

- Corbacho and Schwartz (2007) conclude that FRLs cannot buy credibility or substitute for commitment to prudent fiscal policy.
Selected References


Thank you!