A LONGER-TERM ORIENTATION TO THE BUDGET PROCESS

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A LONGER-TERM ORIENTATION TO THE BUDGET PROCESS

1. A key item on the agenda of the 2002 meeting of the Working Party of Senior Budget Officials, which was hosted by the White House Office of Management and Budget in Washington, D.C., was how to incorporate a longer-term orientation to the budget process.

2. Member countries face a number of expenditure issues that can be considered long-term in nature. The ageing population is recognised as the greatest long-term issue facing Member countries. Other issues are smaller in comparison and not as uniform across Member countries. These include areas where pressure is building up for future spending through “insufficient” levels of current spending, i.e. the adequacy of infrastructure and other capital spending; and issues that loom in the background and have the potential to become major expenditure items, i.e. government loan and guarantee programmes. Their very nature dictates that they be viewed in the context of more than a single year.

3. Delegates at the meeting agreed that the introduction of medium-term expenditure limits had played a leading role in the successful fiscal consolidation efforts of recent years. The use of long-term expenditure forecasts was not as commonly and systematically used in Member countries.

4. Delegates noted that the information basis for forecasting long-term expenditures was robust in most cases. OECD governments have a good understanding of the enormous fiscal consequences of demographic changes, and of the mix of policies that will be needed. However, this has not so far led to the necessary political decisions to adopt those policies -- and the later countries start, the more severe must be the remedies. The key issue was how this information could be presented in a more accessible form to the general public. At present, it was mainly of interest to an expert audience. It was believed that a greater understanding of these issues by the general public was essential to overcoming political reluctance to enact major reforms in this area. This is the focus of the Working Party’s future work in this area.

5. The accompanying paper on Multi-Year Budget Forecasts gives an overview of practices employed in Member countries for extending the time horizon of the budget to a medium- and long-term timeframe.

Questions for discussion:

1. How do participants assess the approaches presently being applied in Member countries for incorporating a more long-term orientation to the public budgeting and management process?

2. How can policy actions for the long-term be stimulated, as it takes time for the benefits to politicians and individuals of such actions to become apparent?

3. What is the appropriate role for central agencies in promoting a longer-term perspective in the public sector?
MULTI-YEAR BUDGET FORECASTS

6. This paper examines how the traditional budgeting process has been amended to incorporate a more long-term orientation through the use of multi-year budget forecasts.

7. The term "multi-year budget forecasts" is used in this paper. It should be emphasized that these are not multi-year appropriations. Rather, these are rolling forecasts of revenues and expenditures for future years that are updated periodically based on the latest available information. They can thus be seen as political and management tools, rather than as legal tools.

8. This paper is organized into four sections. The first section provides some background to multi-year budget forecasts and the problems encountered with their early application; the second section discusses the key objectives of multi-year budget forecasts; the third section discusses the methodology and main implementation issues involved in multi-year budget forecasts; the fourth section concludes with some overall remarks.

Background

9. Budgets are enacted on an annual basis in Member countries. This short-term time horizon is often criticized for impeding effective expenditure management. Decisions on resource allocation are said to be made on an ad hoc or piecemeal basis while the implications of past and present decisions beyond the next year are neglected. This is not a new or recent criticism. Most Member countries have implemented multi-year budget forecasts, in one form or another, to overcome the acknowledged shortcomings of the annual budget exercise.

10. Multi-year budget forecasts themselves are, however, not without their own problems, and it is worth noting these at the outset of our discussion. The United Kingdom was a pioneer in the area of multi-year budget forecasts in the 1960s and 1970s, and encountered significant problems. These problems can be divided into three groups. Most of these problems have been experienced by other Member countries as well.

   – First, there was a tendency to overestimate the growth potential of the economy when making the multi-year budget forecasts. This made excessive resources available in the forecast period and created an upward pressure on public expenditure.

   – Second, ministries and departments viewed their resource allocations in the forecast period as an entitlement. This made subsequent downward revisions in expenditures difficult, even when it became clear that the basis on which the allocations were made was not correct.

   – Third, the multi-year budget forecasts were made in real terms rather than in nominal terms. In the 1970s, when economic growth subsided and inflation accelerated rapidly, the expenditure forecasts were adjusted automatically for increases in prices while revenues suffered. This created further pressure on public finances.
11. The above experience caused many to view multi-year budget forecasts with some suspicion. It must, however, be observed that the early multi-year budget forecasts took place in an environment of rapid expenditure growth, not expenditure retrenchment as is the case today. Regardless, action has been taken to rectify the specific problems identified above. First, Member countries are systematically making use of more "prudent" economic assumptions in order to avoid having excessive resources made available. The increased number of private institutions making economic forecasts has also served as a discipline in this regard. The use of more prudent economic assumptions has tended to eliminate the second problem identified above. Third, multi-year budget forecasts are now invariably made in nominal terms, not real terms.

12. The discussion in the remainder of this paper focuses on the expenditure side of the budget. However, the importance of employing prudent economic assumptions for the revenue side of the budget cannot be emphasised enough, as they play a primary role in establishing the overall level of resources available. The political sensitivities involved in this regard should not be underestimated.

Objectives

13. In discussing the specific objectives of multi-year budget forecasts, it is necessary to distinguish between medium-term budget forecasts and long-term budget forecasts. Medium-term budget forecasts can be defined as extending 3-5 years beyond the next budget year, whereas long-term budget forecasts can be defined as extending for several decades beyond the next budget year.

14. Most Member countries employ medium-term budget forecasts, with a 3-year time horizon being especially widespread. The use of long-term budget forecasts is not as widespread nor as uniform across Member countries. Some Member countries do not make long-term budget forecasts at all, while other Member countries, such as the United States and Denmark, make comprehensive forecasts encompassing both the revenue and expenditure side of the budget for 30-40 years into the future. Between these "poles" there are examples of a wide range of systematic and ad hoc long-term budget forecasts in Member countries.

Medium-term budget forecasts

15. The objective of medium-term budget forecasts is generally to increase discipline over government expenditures. This is achieved, inter alia, by an interplay of the following:

- By setting overall fiscal policy objectives and making explicit how the government will meet them over a number of years, and by translating these into operational terms, thus establishing a ceiling for expenditures.

- By showing the cost of continuing existing policies. This generally reveals that very limited, if any, additional resources are available if the government's fiscal policy objectives are to be met. This serves to impose self-discipline on ministers in proposing new expenditures.

- By illuminating the budget implications of decisions in next year's budget for which expenditure may not be fully reflected in the budget. This can refer to (1) the operating costs of various capital projects being launched, (2) programmes that come into effect late in the budget year, thus not exposing their full costs in the initial year, (3) programmes for which spending implications may not be fully reflected under the circumstance prevailing during the budget year but will become more actual in outyears.
16. The last measures are especially relevant as a preventive device in the budget formulation stage, i.e. by exposing the full costs of proposals by ministers and showing that their acceptance and implementation would be incompatible with achieving the government's medium-term fiscal policy objectives.

17. There is substantial experience with medium-term budget forecasts in Member countries, and there appears to be general satisfaction with their application and their role in facilitating fiscal discipline.

**Long-term budget forecasts**

18. The objectives for medium-term budget forecasts are operational in nature and are not appropriate for a long-term forecasting horizon. The objectives of long-term budget forecasts need to be more strategic in nature.

19. The primary objective of long-term budget forecasts is to identify and expose adverse expenditure trends at an early stage, i.e. to act as an early warning system. This will then enable decisions to be taken in time to prevent, moderate and/or finance these expenditures. Otherwise, looming expenditures may go unnoticed until it is too late to properly address them and their magnitude becomes greater than may have been necessary. Long-term budget forecasts are also used to focus attention on the unsustainability of current policies.

20. The principal application of long-term budget forecasts has been to capture the impact of changing demography on government finances, as the ageing population is by far the greatest expenditure trend facing governments. Other areas of expenditure are generally not forecasted on a micro level but are rather said to increase in aggregate by a set percentage. There appear to be two reasons for this. First, the scale of increased expenditures in other categories is smaller and it is simply not practicable to make a detailed forecast for each of these expenditure categories. Second, there is a basic suspicion of the applicability and accuracy of long-term forecasts in general. The fact that the long-term forecasts can be characterized as incorporating only known demographic changes serves to alleviate this and make them more acceptable.

21. Long-term budget forecasts are much rarer than medium-term budget forecasts, which are employed in most Member countries as noted earlier. Some Member countries appear to dismiss any forecast that extends decades into the future almost as a matter of principle. Other Member countries recognize the inherent limitations of the long-term horizon, but see the forecasts as valuable for exposing the impact of changing demography and the general trend for government finances. Their greatest value has, however, been described by some as simply forcing people to think about the future; the numbers themselves are of less value.

22. It should also be noted that multi-year budget forecasts are not always used to give indicative funding levels to individual agencies and specific programmes for the duration of the forecast period. In many cases, the forecasts are presented in a very aggregated format. This is to prevent agencies and programmes from claiming “ownership” over these funding levels in case downward revisions become necessary. The external transparency of the forecasts also varies across Member countries.

**Methodology and key issues**

23. This section discusses the methodology and key issues associated with formulating multi-year expenditure forecasts. The discussion here focuses on long-term expenditure forecasts, as medium-term forecasts are generally formulated through the same methodology and procedures applied in the annual
budget exercise. To the extent that they deviate from this, they generally incorporate elements of the methodology for long-term forecasts as described below.

24. In making long-term forecasts, government expenditure is generally divided into three groups: (1) expenditures that are directly sensitive to changes in demography; (2) expenditures that are not directly sensitive to changes in demography; and (3) interest expenditures. The forecasting methodologies for each group are discussed below.

25. Long-term forecasts are generally formulated on the basis of continuation of existing policies as the baseline scenario. Alternative scenarios may also be presented incorporating the impact of specific policy changes being proposed or under consideration.

**Demographically sensitive expenditures**

26. As previously stated, the aim of long-term forecasts is primarily to capture the impact of changing demography on government finances. The first step is therefore to identify those parts of the budget that are demographically sensitive and forecast them into the future.

27. It can be difficult to identify all parts of the budget that are demographically sensitive. Some parts are readily identified as eligibility for the respective programmes is determined by age, old-age pensions being a prime example. Identifying other parts requires more careful study, as eligibility for the respective programmes is not determined by age although the recipients of the programmes come predominantly from certain age groups. Examples of expenditures that can be characterised as being demographically sensitive to a significant degree include:

- Day-care Institutions
- Primary schools
- Secondary schools
- Universities
- Financial assistance to students
- Adult education (continuing learning)
- Housing assistance / rent subsidies
- Unemployment insurance benefits
- Primary health care
- Hospitals
- Sickness benefits
- Maternity/paternity benefits
- Disability pensions
- Residential nursing homes
- Home help
- Old-age pensions
− Early retirement benefit
− Civil service pensions.

28. In addition to programmes that have age as an eligibility criterion, the above list reveals programmes such as housing/rent subsidies, unemployment benefits, disability benefits, hospitals, and sickness benefits as being demographically sensitive.

29. In forecasting expenditures for these demographically sensitive programmes, a three-step process is generally followed. First, current expenditure for each programme is divided across the recipients of that programme by age. Thus, a per capita cost is arrived at for each programme by age. This can of course be subject to difficulties. Second, the estimated per capita costs of each programme are estimated to rise by a certain percentage. These percentages are discussed further in the next section of this paper. Third, the country's future demographic profile is projected with the expenditures for each programme changing in line with the changes in each age group's population and estimated take-up rate.

30. The take-up rate refers to what percentage of the population in each age group is a recipient of a specific programme. This is generally a function of labour force participation rates. Changes in labour force participation rates will therefore affect the take-up rates. The key issues that studies have identified as impacting the take-up rate are as follows:

− Changes in unemployment rates;
− Increased labor force participation of women;
− Changing patterns of female participation associated with changes in the age of having a first child;
− Decreased labour force participation at older ages, particularly of men;
− Less time in the workforce reflecting longer periods spent in education; and
− A trend to increasing part time work as a proportion of all work.

31. All these factors have to be taken into account in determining whether the take-up rate for a given programme is likely to change in the future. For example, how will increased labour force participation rates for women affect the demand for children’s day care institutions?

32. Other uncertainties surrounding demographic projections include estimating fertility and mortality rates. This is especially true for estimating future mortality rates at older ages when the impact of today's "healthy lifestyles" will become apparent. Countries with a tradition of immigration face an added uncertainty.

33. Some programmes, notably health care and long-term care for the elderly, are also difficult to forecast due to changing technology. Technology in this area is advancing so rapidly that making forecasts decades into the future based on today's technology involves serious uncertainties.

Nondemographically sensitive expenditures

34. Programmes that are not identified as being directly sensitive to changes in demography are said to increase by a set percentage. Individual programmes are not estimated separately: the set percentage is
applied on an aggregate level. These percentages are also applied to the per capita costs of the
demographically sensitive programmes outlined above.

35. The percentages used for this purpose vary widely. They can be policy-oriented in the sense that
expenditures will rise by a certain set percentage point annually, usually lower than the historical trend.
They can also be said to increase by the same rate as the forecasted growth rate of the economy as a whole.
In other cases, several different scenarios for expenditure growth can be presented.

36. Such assumptions are used given the unfeasibility of forecasting every expenditure item on a
micro basis for a long-term time horizon.

Interest expenditure

37. Interest expenditure is the third group of forecasted expenditures. Three items determine the level
of interest expenditures. First, the overall volume of debt. Second, the structure of debt (short-term bills
vs. long-term bonds, domestic currency-denomination vs. foreign currency-denomination, indexed debt vs.
non-indexed debt, etc.). Third, the interest rate for each type of debt. The overall level of debt feeds back
from the rest of the long-term forecast. The structure of the debt is generally assumed to remain constant.
The interest rate to be employed is thus the major question to be determined in forecasting interest
expenditures. It should, however, be emphasized that debt management is a very dynamic function. For
example, changes in the structure of the debt and the application of various hedging vehicles can impact
substantially on the overall level of interest expenditures.

38. The appropriate interest rate for forecasting purposes is generally assumed to be either the current
level of interest rates or the average of previous years’ (3-5) interest rates, depending on economic
circumstances.

39. Fiscal consolidation efforts are often promoted on the grounds of the positive impact they
will have on long-term interest rates. Accordingly, most Member countries assume that long-term interest
rates will fall as fiscal consolidation efforts proceed. This is a very sensitive area and prudence is of the
essence, as is the case with the economic assumptions underlying the revenue side of the budget.

Overall comments

40. The problems associated with the annual nature of the budget process have been recognized
by Member countries, and techniques have been implemented to incorporate a more long-term time
horizon to the budget process.

41. Following early difficulties, most Member countries now employ medium-term budget
forecasts and report general satisfaction with their use. A number of Member countries are employing
long-term budget forecasts and more are likely to do so in the near future. These forecasts have, however,
been limited to capturing the fiscal impact of changing demography, i.e. the ageing population. Other long-
term issues, such as the adequacy of infrastructure provision, have not been incorporated into these
forecasts.

42. The external transparency of these forecasts varies across Member countries. Practices also
vary as to whether these forecasts are used to give indicative funding levels to individual agencies and
programmes for the duration of the forecast period.
43. Finally, it must be reiterated that preparing multi-year budget forecasts will always involve uncertainty, and various aspects of them will be open to debate as to the appropriate assumptions to be used. It is therefore important to state clearly all the assumptions underlying the forecasts, so that others can comment on their applicability and present different scenarios using different assumptions if they so desire.