

Aggregate expenditure ceilings and allocative flexibility

by
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This article shows how to combine top-down budgeting – in the core sense of the establishment of a hard aggregate expenditure ceiling at the start of the budget preparation process – with flexibility in the allocation of the aggregate ceiling between spending ministries during budget preparation. It argues strongly against determining spending ministry shares of the aggregate expenditure ceiling without any prior opportunity for them to present formal new spending proposals. The keys to reconciling top-down budgeting with allocative flexibility are: the baseline/new policy distinction; good forward estimates; a government-wide new policy pool; and spending review.

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1. Overview

Top-down budgeting is today widely regarded as a key element of good budgeting practice, and with good reason. In its core sense, agreed by all, top-down budgeting calls for the budget preparation process to be framed by a hard aggregate expenditure ceiling – approximately speaking, a limit which applies to the totality of government expenditure. The aggregate ceiling should be set in a top-down manner, which means that it is set at the start of the budget preparation process prior to any consideration of “bottom-up” spending requests from spending ministries. It should also be hard in the sense that, once set, it is essentially not varied during the budget preparation process. Establishing and enforcing such an aggregate expenditure ceiling is today generally viewed as crucial to ensuring that aggregate expenditure does not grow faster than is consistent with government’s aggregate fiscal policy objectives, and in particular with deficits and debt discipline.

The view that hard aggregate expenditure ceilings should be set during the budget preparation for next year’s budget represents common ground among all proponents of top-down budgeting. Some, but not all, top-down budgeting advocates go further and argue that the same should apply to the aggregate expenditure ceilings established for the outer years of the medium-term expenditure framework. In other words, they suggest that outer-year aggregate expenditure ceilings should also be hard, as is the practice in countries such as the Netherlands and Sweden. Such hard medium-term aggregate expenditure ceilings are seen primarily as a means of preventing pro-cyclical increases in expenditure during the upswing of the business cycle. This is essentially the same as the justification of expenditure rules.

All of this pertains to aggregate expenditure ceilings. However, there is a school of thought which advocates the application of the top-down approach not only to aggregate expenditure, but also to setting budget allocations of individual ministries. In other words, individual ministry shares of the aggregate expenditure ceilings also should be set in a purely top-down manner before ministry spending requests are considered. During the preparation of the annual budget, these ministry ceilings should in this view be hard, with ministries either barred or heavily discouraged from presenting spending plans which breach the ceilings they have been given.

Some among this school of thought go even further and suggest that hard top-down ministry ceilings should be set not only for the coming budget year, but for the outer years of the medium-term framework. In other words, they argue that in, say, 2013, the government should set hard ceilings for the Ministry of Health and all other spending ministries not only for FY2014, but also for FY2015 and FY2016.

This view has arisen as a simple response to the very real challenge of how to prepare the budget in the context of an aggregate expenditure ceiling. If one sets a hard aggregate expenditure ceiling, the practical challenge during budget preparation is how to share the aggregate ceiling between ministries, all the while ensuring that the ceiling is not exceeded. This is no trivial matter. The imposition of the aggregate ceiling is intended to

contain the upward pressure on spending arising from large numbers of “bottom-up” spending requests from ministries during the budget preparation process. However, unless processes exist to contain ministry requests in some manner, budget decision makers may be tempted to increase the aggregate ceiling during the budget preparation process in order to escape the tough zero-sum constraint imposed by an aggregate ceiling.

This article challenges this school of thought. While strongly endorsing top-down budgeting in its core sense of the use of hard aggregate expenditure ceilings, the article rejects the application of a simple top-down approach to the allocation of the aggregate expenditure ceiling between individual spending ministries. It argues against setting ministry allocations before ministries have the opportunity to formally present spending proposals.

Moreover, with respect to the setting of ceilings for the outer years of the medium-term expenditure framework, this article suggests that setting hard outer-year ministry ceilings is appropriate only in a minority of relatively advanced countries. In most countries, outer-year ceilings should be indicative rather than hard.

The key problem with an entirely top-down process for setting ministry ceilings is that it can seriously undermine the pursuit of allocative efficiency by making ministry shares of the aggregate expenditure ceiling more rigid. Setting hard ministry ceilings before spending ministries have had the opportunity to present formal new spending proposals deprives the budget preparation process of an information input which is absolutely essential if government is to optimise the allocation of its limited resources. A completely top-down approach to setting ministry ceilings might appear to score high on the criterion of aggregate fiscal discipline. However, budgeting techniques should not be judged solely on this criterion, but also on the extent to which they promote improved expenditure effectiveness and efficiency. Microeconomic considerations should be given as much weight as macroeconomic ones.

In the light of this problem, the article turns to the best means of resolving the tension between a purely top-down aggregate ceiling and the bottom-up pressure for spending increases during the budget preparation process. The article outlines certain budget preparation techniques which can ensure that ministry allocations do not in total exceed the aggregate ceiling while at the same time preserving and enhancing flexibility in the reallocation of resources between ministries. In particular, it argues for:

- the use of the top-down approach to setting ministry baseline ceilings – that is, the component of their budget allocations designed to cover existing programmes and capital projects;
- the treatment of the available fiscal space – the funds available for new spending – as a government-wide new policy pool, to be allocated during the budget process taking into account ministry new spending proposals;
- the systematic scrutiny of ministry baseline expenditure via spending review to increase fiscal space through both efficiency savings and cuts to low-priority and irredeemably ineffective programmes.

The structure of the article is as follows. First, the scene is set by clarifying the concept of expenditure ceilings and briefly noting the benefits of setting an aggregate ceiling. Then the focus shifts to the process for setting ministry allocations consistent with the aggregate ceiling. The notion of top-down setting of ministry ceilings is critiqued, and an alternative approach outlined. In this context, brief consideration is given to the situation of less

advanced countries which may not be able to fully implement relatively sophisticated budget preparation techniques. The article then turns to the question of medium-term ministry ceilings, considering the pre-conditions for an effective system of hard medium-term ceilings and the implications for countries which do fulfill those pre-conditions. Concluding remarks follow.

2. What is an expenditure ceiling?

Expenditure ceilings are quantitative upper limits on the amount of expenditure which are set for specific years and which are applied during the budget preparation process. For example, if a government decides early in the budget preparation process that aggregate government expenditure excluding interest payments will not exceed USD 380 billion in the coming year, it is setting an (aggregate) expenditure ceiling. Expenditure ceilings should not be confused with the expenditure limits set by parliament when it passes the budget law and which limit expenditure only during the execution of the budget. An expenditure ceiling constrains budget preparation as well as budget execution.

An aggregate expenditure ceiling is a limit which covers all or most government expenditure.¹ A ministry expenditure ceiling, analogously, is a limit which covers all or a large portion of the ministry's expenditure.²

A hard expenditure ceiling is, roughly speaking, a ceiling which is intended to be fixed and not open to variation during the budget preparation process. By contrast, an indicative ceiling is a ceiling which is understood as being open to some degree of modification during budget preparation but which is nevertheless expected to have some constraining impact on the levels of expenditure approved in the budget when it is finalised (otherwise it would not make sense to call it a "ceiling"). Both types of ceilings may be contrasted with expenditure forecasts – also known as forward estimates – which are mere projections and are not necessarily intended to influence or determine in any way the future evolution of expenditure (unless, of course, used as the basis for setting ceilings).

Expenditure ceilings are different from expenditure rules, which may be defined as limits on expenditure which are formulated in such a manner as to have continuing application.³ A commitment that government expenditure will not exceed 35% of GDP is, for example, an expenditure rule. Expressed differently, an expenditure ceiling which applies to year n implies nothing about the limit, if any, which might apply to year $n + 1$. By contrast, an expenditure rule is formulated in such a manner as to apply to both years and subsequent years.⁴

Any expenditure rule must be given effect through the setting of expenditure ceilings for specific years, which are consistent with the expenditure. For example, if the expenditure rule is that aggregate expenditure will not exceed 35% of GDP, then at the start of the preparation of the FY2014 budget it will be necessary to calculate the dollar value of aggregate expenditure which this equates to during FY2014 and to then apply this as an aggregate expenditure ceiling. So if there is an expenditure rule, there must also be expenditure ceilings. The converse is not true, however: expenditure ceilings may be set even if there is no expenditure rule.

3. Why aggregate expenditure ceilings?

As noted above, the fundamental rationale for setting aggregate ceilings is to ensure that the ministry allocations decided in the budget preparation process are consistent with aggregate fiscal policy objectives. In the top-down process, the highest executive budget decision-making institution (which we will call the “Cabinet” as shorthand⁵) sets an aggregate ceiling which reflects macro-fiscal and revenue policy objectives prior to any consideration of ministry spending requests (Ljungman, 2009).

On the other hand, the main rationale for setting multi-year aggregate ceilings is to ensure that expenditure does not rise in tandem with purely cyclical revenue increases during the boom phase of the business cycle – in a way which would be possible if only budget deficit rules applied – leading to the structural deterioration of public finances. In addition, multi-year aggregate ceilings might also be employed to support medium-term debt reduction or tax reduction objectives (EC, 2010). To achieve any of these objectives, it is clearly important that the multi-year ceilings are hard rather than purely indicative. The use of hard multi-year aggregate ceilings was pioneered by Finland, the Netherlands and Sweden, but is increasingly now being extended to other countries. For the same reasons, there is growing support for the use of expenditure rules, such as the new EU approach which (simplifying) limits growth in aggregate expenditure to the trend growth rate of GDP.

4. Setting ministry shares of the aggregate ceiling

Once the case for aggregate ceilings is accepted, the question arises of how to operationalise them in the budget preparation process. On this question, there is a school of thought which holds that the answer is a two-stage budget preparation process in which, first, both the aggregate and ministry ceilings are set by the Cabinet and, second, ministries prepare detailed budgets within the ceilings given to them. In Tommasi’s words (2010:89), there should be:

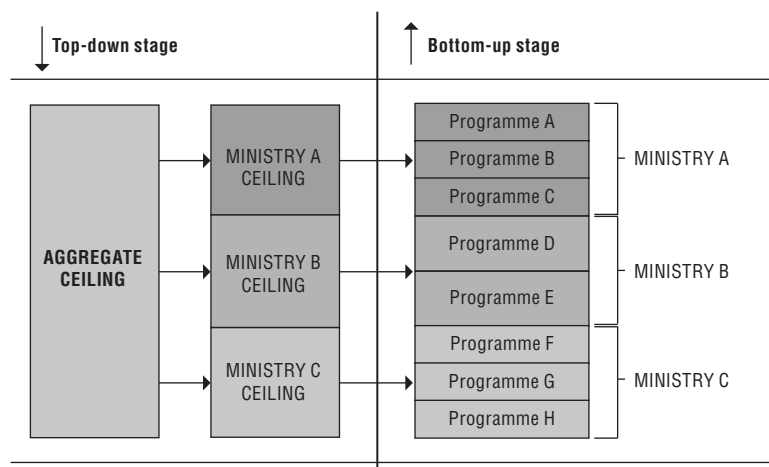
- “a ‘framework’ stage – often referred to as the ‘strategic’ phase – during which are determined the overall budgetary objectives (total expenditure, deficit, etc.) and the sectoral allocation of resources, including ministry expenditure ceilings...
- a stage of preparation by ministries of detailed expenditure estimates which respect the ministry ceilings which were set ... during the strategic phase.”

In this formulation, the determination of ministry ceilings becomes – like the setting of the aggregate ceiling – a top-down process in which ministries are quite deliberately excluded from presenting spending proposals before the ministry ceilings are set. The “bottom-up” part of the budget preparation process is entirely or largely restricted to ministries making proposals as to how they will spend their respective ceilings (Renzi and Smith, 2005; Kim and Park, 2006:88). As this implies, the ministry ceilings, once set, are hard during the preparation of the annual budget.

This wholly top-down view of how ministry ceilings should be set may be described graphically in Figure 1, where the preparation by each spending ministry of its budget estimates within the top-down ceilings allocated to it is represented as a process of proposing an allocation of its ceiling between the programmes for which it is responsible.

A variant on this approach calls for hard sectoral ceilings, rather than ministry ceilings, to be set in a top-down manner at the strategic stage. Sectoral ceilings cover several ministries, and in this variant of the process the allocation of each sectoral ceiling

Figure 1. The top-down view of how to set ministry ceilings



between sector ministries is determined in the second stage of the budget preparation process (e.g. Schiavo-Campo and Tommasi, 1999, Chapter 4:8). This model draws its inspiration from the “sector-wide” approach which Canada briefly applied to the expenditure allocation process before abandoning it (Good, 2007). For simplicity, this article focuses on the version of the model which requires the top-down determination of ministry ceilings. However, the problems discussed here apply equally to the sector ceilings version of the model.

The widespread influence of this purely top-down approach to setting ministry expenditure ceilings is highlighted in the World Bank’s most recent volume on medium-term expenditure frameworks (MTEFs), which advocates an integrated budget preparation/MTEF process in which “hard” ministry ceilings are set prior to the preparation and consideration of spending ministry budget submissions (World Bank, 2013: loc. 1200).

In the MTEF context, ministry expenditure ceilings are typically set for a three-year time horizon, which raises the question of how hard the outer-year ceilings should be. Many advocates of the top-down approach to setting ministry budget ceilings propose that ministry expenditure ceilings should be hard only for the coming budget year, and that outer-year ministry ceilings should be purely indicative. This was, for example, the view taken in the World Bank’s seminal *Public Expenditure Management Handbook* (World Bank, 1998:47) which introduced the MTEF concept. The view that outer-year ministry or sector ceilings in the MTEF should be indicative rather than hard probably remains the majority opinion within the PFM (public financial management) technical assistance community. It is also predominant international practice, including in most advanced countries (ranging, for example, from the long-established Australian approach to medium-term budgeting to the new Austrian MTEF).

There are, however, many who believe that not only annual ministry ceilings but also outer-year ministry ceilings should in general be hard. As Kim and Park (2006:95) note, many advocates of top-down budgeting consider that “the top-down budgeting system cannot work as expected without an effective medium-term budget framework ... [which is] operationalised by establishing **hard** budget constraints for individual ministries and programmes over a span of multiple years” (emphasis added). This is a point of view which advocates the generalisation to the entire world of the practice of a limited number of

advanced countries which currently set hard ministry expenditure ceilings for the outer years of the medium-term expenditure framework (the United Kingdom being the prime example).

The analysis which follows examines, first, the proposition that ministry ceilings should be set in a top-down manner. It then critically assesses the proposition that medium-term ministry ceilings should be hard rather than indicative.

5. Top-down setting of ministry ceilings?

The case for using a top-down process to set ministry ceilings is that excluding the presentation of ministry spending proposals prior to the determination of ministry ceilings:

- prevents the finance ministry from being overloaded by large numbers of new spending proposals which in aggregate greatly exceed available resources and which it is beyond the resources of the ministry to review properly;
- saves spending ministries from wasting a great deal of effort preparing and costing spending proposals which have no chance of being funded given available resources;
- greatly reduces the likelihood that the political leadership will succumb to bottom-up pressure during the budget preparation process by deciding to increase the aggregate ceiling.

More broadly, setting both aggregate and ministry ceilings at the very start of the budget process seems like an obvious and simple way of ensuring that ministry ceilings do not in total exceed the aggregate ceiling.

It is crucial to note that only hard ministry ceilings could be expected to constrain new spending requests in this manner and thus produce the alleged benefits of the top-down ceiling-setting process. If ministries knew that ceilings were indicative and therefore open to modification, they would presumably not hesitate to present additional spending proposals in excess of the ceilings.

As attractive as the case for hard top-down ministry ceilings might appear to be from the point of view of aggregate expenditure control, there is a major downside – namely that determining ministry ceilings without any consideration of bottom-up ministry requests must inevitably undermine allocative efficiency. Allocative efficiency means choosing from among the available alternative expenditure options those which will deliver the greatest benefits to the community. Choosing the best available spending options requires prior knowledge of what those options actually are, and such knowledge will for the most part not be available to the Cabinet and finance ministry if spending ministries are barred from putting new spending proposals forward. Expressed differently, the information constraints facing central decision makers are so great that only with the assistance of extensive bottom-up expenditure proposals can they have any hope of doing a reasonably good job of allocating budgetary resources.

It is true that advocates of the top-down setting of hard ministry ceilings envisage that, even though bottom-up requests are to be banned, the ceilings will nonetheless be set “according to policy priorities” (e.g. Kim and Park, 2006:88). What this usually means is that, during the “strategic” phase of budget preparation, the Cabinet identifies the areas of government services to which it wishes priority to be given in the allocation of resources – presumably based on the emergence of new policy challenges or on changed views about

priorities – and then sets the ministry ceilings based on these priorities. The problem with this arrangement is that the mere identification of priorities to which the budget should pay attention does not provide sufficient information to appropriately determine specific ministry ceilings. Ministry ceilings can only logically be set in the knowledge of the specific new programme/project options which can give effect to those priorities. Concrete new programme proposals must, in the main, come from the relevant spending ministries: in other words, they must be bottom-up.

It is undoubtedly good practice for the Cabinet to discuss expenditure challenges and priorities during the initial strategic phase of the budget preparation process, and to inform spending ministries of the government priorities it wishes to see reflected in their spending requests. But it makes no sense for the Cabinet to proceed directly from the consideration of priorities to the determination of ministry ceilings, skipping any intervening consideration of concrete spending proposals.

In any event, one should be very cautious about the feasibility of an entirely top-down determination of ministry ceilings. In practice, it is not possible to prevent ministries from putting forward some major new spending proposals during the discussions leading to the setting of supposedly “top-down” ministry ceilings. While a top-down process might eliminate the presentation of formal ministry budget requests prior to the establishment of ministry ceilings, it would certainly not eliminate the informal presentation of major new spending proposals. It is to be expected that, in the Cabinet discussions during the strategic phase of the budget preparation process, individual ministers would argue for increased ceilings for their own ministries largely by referring to significant new spending proposals which they would like to see funded. There is also likely to be considerable behind-the-scene lobbying of the president/prime minister, again based in large measure on specific new spending proposals.

This means that the supposedly top-down process of setting ministry ceilings ends up leading to the replacement of formal processes for the consideration of bottom-up spending proposals with informal processes. This is undesirable. One of the hallmarks of a good budget preparation process is the existence of clear formal routines for the presentation and appraisal of new spending proposals. These routines should include the requirement that all new spending proposals are presented with prescribed supporting information in a standard format, as well as a standard process for the review of such spending proposals by the finance ministry and other relevant “central agencies” such as the office of the president or prime minister. By encouraging the informal presentation of major new spending proposals during the strategic phase of the budget preparation process, the supposedly top-down process undermines these formal routines. The inevitable result will be the *de facto* approval of major initiatives by the Cabinet without the benefit of formal submissions or detailed critical analysis by central agencies.⁶ In addition, because the time available for discussion during the Cabinet deliberations in the strategic phase of the budget preparation process will inevitably be very limited, it is likely that only a handful of the most powerful ministers will enjoy the opportunity to raise new proposals which influence ministry ceilings.

6. How hard are the top-down ministry ceilings?

It is therefore hardly surprising that in practice – as made clear by Kim and Park (2006:94, 107-108) – a number of countries with supposedly top-down processes for setting

ministry ceilings in fact permit bottom-up new spending proposals before finalising the ceilings. A typical example is Denmark where, according to Blöndal and Ruffner (2004:58):

Spending ministries ... submissions are [supposed] to be in line with the expenditure ceilings given to them in February. In reality, the amounts are generally in excess – either due to the ministries claiming that the cost of operating unchanged policies is higher than what was assumed, or because they will be making claims for new initiatives. ... the submissions by ministries reflect the fact that they believe that the Ministry of Finance has a “kitty” (reserve) at its disposal. This may or may not be the case in individual years. There are strong procedures in place to justify any bids in excess of the initial expenditure ceilings allocated.

Sweden is supposedly the prime example for top-down setting of ministry ceilings. In theory, the Swedish ministry ceilings are all set at a Cabinet retreat one month into the budget preparation process, prior to any bottom-up input, and these ceilings then remain hard. In practice, however, ministries do present budget requests in excess of their top-down ceilings (Gustafsson, 2004:63).

The advocates of hard top-down ministry ceilings have considerable difficulty with this issue and cannot be said to present a clear and consistent line. The World Bank's classic *Public Expenditure Management Handbook*, which advocated a quite top-down approach to setting ministry or sectoral ceilings, asserted that the “test of these envelopes [i.e. ceilings] is their credibility ... It would be expected that they would [be] reasonably firm for formulation of the annual budget”. The ambiguity of the word “reasonably” is notable, but it is clear that the emphasis is on firmness. Yet a couple of years later, the principle author of the handbook and architect of the MTEF concept is to be found quite correctly rejecting the notion:

... that ceilings should be immutable once set at the outset of budget preparation. On the contrary, a central purpose of the budget preparation process is to ensure that resources are going to priorities and reflect information on what is working and what is not. (Holmes and Evans, 2003:24)

A similarly contradictory position can be seen in Schiavo-Campo and Tommasi (1999, Chapter 4:34-35) who, immediately after arguing for a completely top-down process of setting hard sector ceilings (“definite budgetary envelopes”) in developing countries, contradict themselves by conceding the possibility that “additional requests from line ministries could be allowed for new programs” in which case only “the principal request [from the ministry] should be consistent with the notified ceilings”.

Holmes and Evans (2003:35) try to square the circle by arguing that “ceilings must be sufficiently fixed ... to be credible but sufficiently flexible to accommodate changing economic conditions, changing priorities and new information”. But this is surely an impossible balancing act. If there is to be significant flexibility to reallocate resources between sectors or ministries, or if significant new policy proposals outside the initial supposedly top-down ministry ceilings are permitted, the system is no longer based on hard ministry ceilings, but rather on indicative ceilings. And it is no longer reasonable to expect that the ceilings will achieve their aim of preventing ministries from putting forward substantial numbers of new spending requests. The supposed advantages of top-down budgeting over bottom-up budgeting disappear.

One searches in vain in the works of advocates of supposedly hard top-down ministry ceilings for any principles which will determine how much money is to be made available

for new spending proposals and how this is to be taken into account when the ministry ceilings are initially set. One is therefore left without any explicit mechanism for ensuring that the initial ministry ceilings, plus new policy proposals accepted later in the budget preparation process, are consistent with the aggregate ceiling.

Potter and Diamond (incidentally, advocates of indicative ministry ceilings) explicitly address the question of availability of funds for new policy proposals in excess of initial ministry ceilings in their classic budgeting manual. They suggest (Potter and Diamond, 1999:18) a “planning reserve” of 1-2% of the aggregate ceiling “so the ministry of finance can assign extra resources later during budget negotiations for the most urgent priorities, without breaching” the aggregate ceiling. Potter and Diamond are undoubtedly on the right track here in suggesting a government-wide pool of funds for new policy (see further on this topic below). However, with a reserve which is so very small, and the difficulty of cutting the initial “indicative” ministry ceilings once they have been advised to ministries, their proposal remains a recipe for allocative rigidity and incrementalism. The size of the planning reserve also seems entirely arbitrary, without any clear relationship to the underlying fiscal space available to government.

All these considerations point to the conclusion that the top-down setting of ministry ceilings, prior to the consideration of formal new spending requests from spending ministries, is in general undesirable and impractical. A sound budget preparation process must preserve the channels by which ministries can formally present new spending proposals prior to the finalisation of ministry ceilings, with those proposals being then subject to rigorous analysis and challenge by the finance ministry and other relevant central agencies. This conclusion is not changed by the fact that the exigencies of a major fiscal consolidation may justify the temporary adoption of a more top-down approach.

7. How to reconcile an aggregate ceiling with allocative flexibility

What type of budget preparation process is capable of reconciling allocative efficiency with aggregate expenditure ceilings? In other words, how can the budget preparation process be organised to give effect to aggregate ceilings while retaining maximum flexibility to allocate budgetary resources to where they will deliver the greatest social benefit? There is no single answer to this question which can be applied to all countries. Differences in technical capacity and institutional structure mean that one size does not fit all. Nevertheless, it is possible to draw on the experience of certain leading countries in order to present a stylised best-practice model which can at least provide a basis for considering how to reform the budget preparation process in specific countries.

The model takes as its starting point the distinction between new spending and “baseline” spending on ongoing programmes and projects. Baseline expenditure is the level of expenditure which would be required across government to continue to provide existing services, meet existing commitments and continue existing capital projects, assuming unchanged expenditure policy (i.e. that no existing services are eliminated or cut back, and that government policies about the level of service are honoured). New spending, by contrast, is funding for the creation of new capital projects, new services or the expansion of existing services. It is the forward estimates of expenditure (mentioned earlier) which provide quantitative estimates of baseline expenditure requirements over the medium-term time horizon. Fiscal space – assuming unchanged expenditure policies –

is then measured by the difference between the aggregate expenditure ceiling and baseline expenditure as indicated by the expenditure forward estimates.

Allocative efficiency clearly requires a budget preparation process which can allocate the resources available for new spending – the fiscal space – to those programmes and ministries where they will be most useful. This requires that fiscal space is treated as a government-wide pool whose allocation is based on the careful evaluation of the alternative spending options.

As a first approximation, fiscal space can be allocated in this way while respecting the aggregate ceiling through a budget process in which:

- all ministries are given hard “baseline expenditure ceilings” – that is, ceilings covering expenditure on their existing programmes and capital projects at their level – equal to the baseline expenditure requirements. These baseline ceilings are established for each ministry at the start of the budget process, in an entirely top-down manner;
- a hard government-wide new policy ceiling is set at the same time, equal to the aggregate ceiling minus the sum of ministry baseline ceilings.

The allocation of the new policy ceiling between ministries is then determined during budget preparation, based on both government priorities and bottom-up ministry proposals. The political leadership would provide guidance for the allocation process by considering its overall priorities at the start of budget preparation, without setting ministry ceilings at that stage.⁷ Ministries would then make detailed formal bottom-up submissions for concrete new spending proposals, which would be subject to searching independent analysis by the central agencies. The allocation of fiscal space might also be framed by explicit principles guiding the division of fiscal space between current expenditure and capital expenditure.

In respect to baseline expenditure, this process would, ideally at least, be entirely top-down – that is, the baseline spending requirements of ministries would be calculated by the finance ministry without any consideration of requests from the spending ministries. “Bottom-up” budget requests would be confined to new policy. Moreover, a clear constraint would have been set on the total value of new spending proposals which could be accepted.

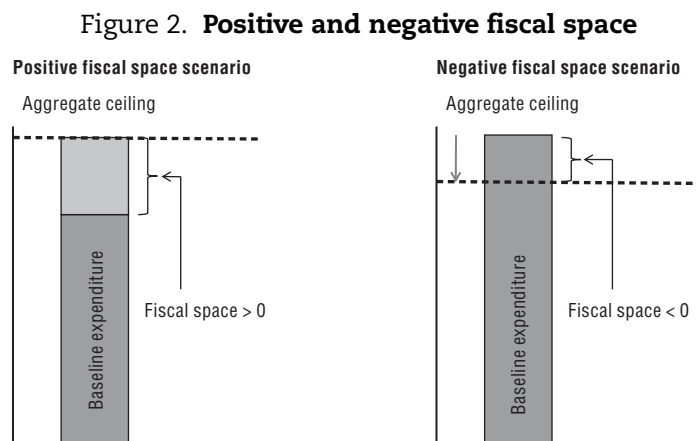
Such a process would score high points for allocative efficiency in respect to new spending. However, this is not enough. Allocative efficiency also requires a capacity to re-examine and reallocate baseline expenditure. A process in which ministry baseline ceilings were set in concrete at the start of the budget preparation process would unnecessarily limit the scope for such re-examination and the allocation. Expressed differently, it would institutionalise budgetary incrementalism (Schick, 2009:8).

The “first approximation” process as outlined above has the further disadvantage of being based on the assumptions that the fiscal space estimated in this manner will always be:

- positive – i.e. that the sum of ministry baseline ceilings (plus other “baseline” government expenditure) will always be less than the aggregate ceiling; and
- sufficient to provide scope for those new spending items which government regards as high priority.

However, it will not always be the case that fiscal space will be positive. Sometimes it may be negative, meaning that baseline expenditure requirements exceed the permissible aggregate expenditure ceiling. This type of situation is particularly likely to arise during

phases of fiscal consolidation, when aggregate ceilings will be set at levels which require significant spending cuts. The contrast between positions of positive and negative fiscal space may be illustrated graphically in Figure 2.



Moreover, even if fiscal space is positive, it may be quite small and therefore insufficient to fund even the highest-priority new spending initiatives.

If fiscal space is negative or insufficient, the only way of respecting the aggregate ceiling while giving effect to important government new spending priorities is to reduce budget allocations to existing services – that is, to cut ministry baseline ceilings by providing less money than required to fully fund baseline spending.

These considerations point to the need to incorporate into the budget preparation process a mechanism which makes it possible to review and cut baseline funding. An enhanced process consistent with this includes the following:

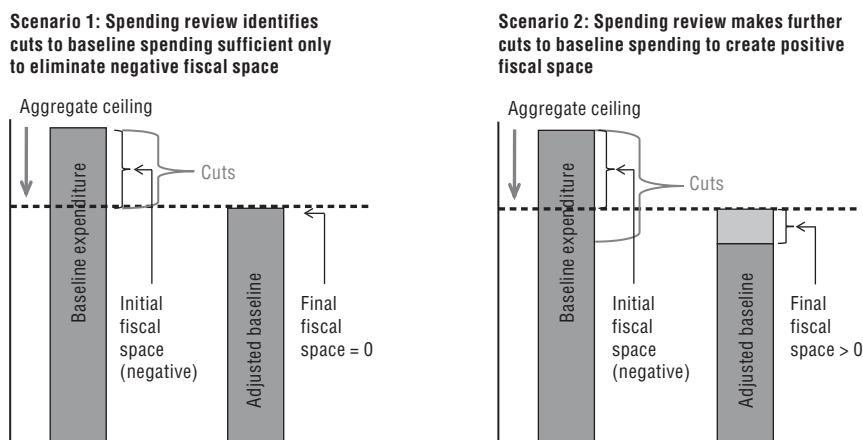
- The baseline ministry ceilings set at the start of the budget preparation process may incorporate cuts to existing programmes (e.g. as the result of any spending review conducted prior to the commencement of the budget preparation process).
- The baseline ministry ceilings are also made explicitly subject to possible reduction during the budget preparation process as the result of a spending review process⁸ – and are therefore hard in the upward direction but flexible in a downward direction.
- Any cuts to baseline ceilings either prior to or during budget preparation increase the new policy ceiling – i.e. the amount of fiscal space available for new spending.

This process transforms the new policy ceiling into a net ceiling in the sense that it limits net new spending – i.e. new spending minus any cuts to existing programmes decided during the budget process.

To expand on the role of spending review in this process, consider the scenario where fiscal space is negative. In this case, it would be impossible for the government to give ministries budget allocations equal to their baseline expenditure requirements as indicated by the forward estimates. To avoid breaching the aggregate ceiling, it would then be necessary to set baseline ceilings sufficiently below the baseline estimates to ensure that fiscal space is not negative. If, in addition, the government wished to have room to fund any new policy under the aggregate ceiling, fiscal space would have to be positive and, to achieve this, baseline ceilings would have to be pushed down further. These scenarios

are illustrated in Figure 3. On the left hand side is the position where, faced with a negative fiscal space, the government decides to cut baselines by only the amount sufficient to ensure that spending does not exceed the aggregate ceiling. In this scenario, there is no fiscal space for new initiatives. On the right hand side, the government goes further with the cuts to baselines, so as to create positive fiscal space to permit some new spending proposals to go ahead.

Figure 3. **Negative fiscal space scenarios**

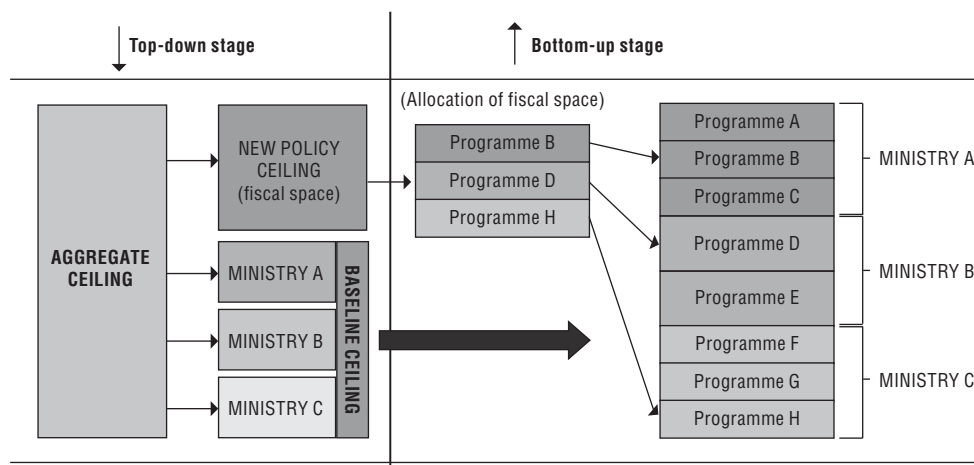


The budget preparation process outlined above remains a highly top-down one in which two types of hard ceiling are set at the very start of the budget preparation process, prior to ministry funding requests. At the same time, it is a process which has the advantage not only of avoiding incrementalism, but also of explicitly linking decisions about the amount of new spending to the matching decisions taken during the budget preparation process on cuts in baseline spending. This provides a pressure valve which permits the acceptance, if appropriate, of additional new spending proposals without raising the aggregate ceiling. To make this work, it is necessary for the finance ministry to maintain throughout the budget process a running tally of the net impact of new spending and cuts.

Such a system maximises allocative flexibility while ensuring respect for the aggregate ceiling. Of course, the capacity of countries to realise the benefits of such allocative flexibility will depend upon how good they are at spending review and the extent to which they have adopted the principles of performance budgeting.

In summary, this is a budget preparation process based on two key principles. The first is the separation of decisions on net new spending – i.e. new spending initiatives and expenditure cuts – from decisions about baseline funding for continuing programmes. The second principle is the imposition throughout the budget process of the constraint that net new spending must not exceed the aggregate expenditure ceiling minus baseline funding. This process may be represented graphically in Figure 4.

What about the top-down budgeting objective of preventing spending ministries from overburdening the budget process with too many new spending proposals? The existence of an explicit new policy ceiling helps, but this is of course a government-wide pool and will attract competing “bids” in excess of the amount available. Particularly important,

Figure 4. **Combining top-down discipline with allocative flexibility**


therefore, is the rigour of the information and analysis requirements which ministries must satisfy in their formal submissions for new spending proposals. If these are tough, they will significantly reduce the number of new policy proposals. In addition, the indication by the political leadership of the government's priority areas for new spending at the commencement of the budget preparation process should act to discourage – without totally preventing – ministries from presenting new spending proposals outside these priority areas. Finally, certain supplementary budget process rules – such as an expectation that ministries will fund minor new spending proposals through internal savings rather than funding requests – can help to contain the numbers of new policy proposals at manageable levels.

8. Technical capacity and the process for setting ministry allocations

In its pure form, the process outlined above requires quite advanced technical capacity in one important area: the preparation of reasonably accurate “forward estimates” of expenditure. Forward estimates⁹ are projections of expenditure (and revenue) on a “current policy” basis – that is, projections of future levels of expenditure and revenue on the assumptions that there are no new spending initiatives and no changes to tax laws, and that all explicit and clear commitments made to future expenditure (including political promises) are taken into account.

The ability to prepare accurate forward estimates of expenditure at least one year ahead is essential if ministry baseline ceilings are, as suggested above, to be set in a purely top-down manner. It is essential because, if spending ministries are to be denied the opportunity to present their own views about the funding they need to continue “current policy” before ministry baseline ceilings are set, the finance ministry needs to be very confident that its own estimates of baseline requirements are accurate. Moreover, if hard multi-year ministry ceilings are to be set, the finance ministry needs to be able to prepare accurate forward estimates not merely for the coming year, but for several years into the future.

There are, however, many countries that are unable to prepare accurate forward estimates even one year ahead. Under these circumstances, to set ministry baseline

ceilings in a purely top-down manner is clearly not feasible. Bottom-up representations from spending ministries on their baseline requirements cannot be denied.

In at least some countries, a modified version of the process for setting ministry baseline ceilings outlined above is, however, practical. In such a process, the finance ministry initially sets indicative ministry baseline ceilings which are as accurate as it is able to make them, but gives spending ministries the opportunity to formally request the revision of these ceilings. Crucially, however, the finance ministry tightly prescribes and limits the grounds upon which such revision may be requested. The most important of these would be mandatory expenditure requirements of which the finance ministry was not aware.¹⁰ In such a process, the finance ministry permits bottom-up input into the determination of ministry baseline expenditure allocations precisely because it is aware that its expenditure forecasting capacity is not (yet) good enough to permit it to determine those baseline allocations unilaterally. However, with such an approach, the expenditure forecasting capacity of the finance ministry improves over time, and the setting of baseline allocations can become increasingly top-down.

Such an approach recognises something which is not acknowledged by most advocates of top-down budgeting – namely, that the degree to which budgeting can be made top-down is in part a function of the technical capacity of the country concerned. It is inappropriate to advocate equally top-down processes everywhere in the world.

9. Multi-year ministry ceilings

As noted at the outset, there are those who believe that not only annual but also multi-year ministry ceilings should be hard. Those of this opinion tend to look to the practices of the handful of advanced countries such as the United Kingdom where governments make hard medium-term budget commitments to ministries. Hard multi-annual ministry ceilings are seen by their proponents not only as tools for expenditure discipline, but also as a means of improving performance by providing ministries with certainty about future funding levels. Such certainty allows ministries to plan and manage on a medium-term basis.

The potential benefits of giving ministries medium-term funding certainty are clear, but there are two main obstacles which make this approach impractical in the majority of countries.

The first is, once again, the quality of forward estimates. If a country is unable to prepare reasonably accurate medium-term estimates of the “current policy” expenditure requirements of ministries, there will be a high risk that the ceilings set for many ministries in the outer years will be either too low or too high. This is not a problem if the ceilings are only indicative, but it is a major problem if they are hard. If the ceilings are too high, the available fiscal space will be underestimated and the capacity to fund new policy commensurately reduced. But if they are too low, the risk will be that, when the outer years arrive, the unrealism of the supposedly hard ministry ceilings will become apparent and the ceilings will probably end up being modified upwards. Expressed differently, the ability to make hard multi-year ministry ceilings stick depends upon the credibility of those ceilings.

Experience has amply demonstrated that poor-quality forward estimates undermine the entire medium-term budgeting process. Countries which have attempted to introduce MTEFs without investing significant effort in the forward estimates process tend,

unsurprisingly, to have been disappointed with the results. In the absence of a system and capacity to produce quality forward estimates, projections of medium-term aggregate spending and revenue tend to be prepared on the basis of the crudest techniques (e.g. updating based only on the application of a general inflation factor) which fail to capture the dynamics of current policy. And the inevitable consequence is that the medium-term sectoral or ministry “ceilings” which are prepared on the basis of those forward estimates and approved in the MTEF have little impact on the actual expenditure approved in the annual budget.

Box 1. Poor-quality forward estimates and MTEFs in the developing world

Fölscher (2007:5) notes that, in Africa: “The quality of forward estimates is poor. They consist far too frequently of the proposed budget for the first year of a multi-year framework, followed by inflation adjusted projections of cost for the outer year ... they pay little attention to, for example, the likely phasing of policy implementation, changes in demand that will effect spending unevenly or the impact of once-off capital spending on the base-year estimates. ... A key aspect of embedding a medium-term perspective therefore is deciding what the rules are for rolling over and adjusting and determining the forward estimates.”

Another typical example of the way in which poor-quality forward estimates have undermined the value of MTEFs in developing countries is Kyrgyzstan, where a review by the IMF in 2008 (Report on Observance of Standards and Codes, “fiscal transparency”) noted that “the costs of government policies and programs are yet to be tracked with an acceptable degree of accuracy to serve as the basis for a well-developed forward estimates system and systematic preparation of the MTBF” (IMF, 2008:16). The following year, a review under the PEFA programme (Public Expenditure and Financial Accountability) made the following observation: “Starting from 2009 the annual budget law is produced for three years on a rolling basis. It is too early to assess the impact of these changes, but it seems that the budgets for the second and third year are merely projections on the basis of expected inflation” (Shambetova et al., 2009:38).

Arguably, countries that are unable to prepare forward estimates of expenditure should not pretend to be setting even indicative ceilings. A better approach for such countries would be to initially focus only on producing medium-term forecasts. Only at the point where these forecasts attain an acceptable degree of accuracy should they be used to set indicative ceilings.

The other danger of setting hard multi-year ceilings is that it will greatly increase allocative rigidity. Locking in ministry ceilings for, say, three years into the future means denying oneself the ability to reallocate resources during that period in accordance with priorities and performance. Unless the country concerned is very good at periodic in-depth reviews of expenditure priorities, the result is likely to be that ministries and programmes which should have their funding cut find themselves more protected from cuts, and ministries and programmes which should receive greater funding find it even harder to attract additional resources. The United Kingdom combined its system of hard multi-year ministry ceilings with periodic in-depth spending reviews. However, spending review – the critical examination of baseline expenditure to identify wasteful and low-priority spending which can be cut to free up additional fiscal space – is something which only a minority of

countries around the world are able to do well. Moreover, undertaking a major spending review every three years is more demanding than undertaking some spending review every year. It follows that developing strong spending review capacity – and, more generally, performance budgeting – should be seen as a prerequisite (along with the ability to prepare good forward estimates) for moving to hard multi-year ministry ceilings.

10. Conclusion

Setting ministry ceilings in a completely top-down manner and then insisting that they be hard – possibly even on a multi-year basis – is superficially attractive to those who focus solely on aggregate fiscal discipline. However, it is crucial – particularly at a time when the need to restore public finances after the financial crisis and to meet longer-term structural fiscal sustainability challenges looms large – not to lose sight of the fact that good budgeting is not only about fiscal discipline, but also about allocative efficiency.

This article has aimed to show that it is possible to enforce hard aggregate expenditure control via expenditure ceilings while maximising the allocative flexibility of the budgeting system. The keys are: the baseline/new policy distinction; good forward estimates; a government-wide new policy pool; and spending review. The article suggests an alternative form of top-down budgeting in which it is not ministry ceilings which are set at the start of the budget process but rather ministry baseline ceilings and the government-wide new policy pool.

Notes

1. It might exclude certain categories of expenditure such as interest payments.
2. It might exclude certain categories of the ministry's spending such as entitlements expenditure which is determined by law (on the grounds that the ministry has no control over the volume of such payments).
3. This is consistent – subject to one qualification – with the IMF definition of expenditure rules (IMF, 2009:5) as “permanent limits on total, primary, or current spending in absolute terms, growth rates, or in per cent of GDP”, which is in turn consistent with the widely accepted Kopits/Symansky (1998) definition of a fiscal rule (of which an expenditure rule is one type) as “a permanent constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance”. The qualification is the substitution of “continuing” for “permanent” application. Replacing “permanent” with “continuing” recognises that a rule might be intended to apply for a defined period of time, or indefinitely, without necessarily being intended to be permanent. A concrete example of an expenditure rule which was intended to have continuing but not permanent application was that enunciated by the Australian government in 2009 as part of its deficit exit strategy from the global financial crisis. Under this strategy, the Australian government committed to return the budget to surplus by restraining real growth in spending to 2% a year once the economy recovered to grow above trend. Once the budget returned to surplus, and while the economy is growing at or above trend, the government committed to retaining a 2% annual cap on real spending growth, on average, until surpluses are at least 1% of GDP.
4. The distinction between expenditure rules and expenditure ceilings is, unfortunately, not always clearly maintained. For example, while the European Commission defines expenditure rules in accordance with the Kopits/Symansky (1998) definition of fiscal rules, it inconsistently treats expenditure ceilings as a type of expenditure rule (see, for example, EC, 2009:87, 90, 268-269, and EC, 2006:162). Similarly, a recent ECB publication appears to conflate expenditure rules and expenditure ceilings (Hauptmeier et al., 2010:11).
5. Of course, the highest decision-making institution on budgetary matters differs with the political system, and in some cases is not the Cabinet (council of ministers) but, say, the president.
6. In addition, the resource allocation bias towards the most politically powerful ministers would be exacerbated, because only they would in general have the weight to be able to raise major new spending proposals.

7. What this would mainly mean in practice is that the leadership would identify particular key problem areas which it would like to see addressed via new spending in the budget.
8. It should be noted that the potential downward flexibility of ministry baseline ceilings raises significant issues. These are perhaps best resolved in the Danish manner of excluding from the baseline ceilings specific programmes which have been identified as the subject of spending review during the budget cycle.
9. Also known by a range of other names, such as “annual reference level update” in Canada.
10. A mandatory expenditure requirement is an obligation to change the volume of services or transfer payments provided to citizens because of a legal requirement or an explicit government policy.

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