



Twinning Project MK11 IB FI 01

“Strengthening the medium term budgeting for effective public financial management”

SUMMARY of the REPORT:

“Assessment of current budget process, practices and capacities for fiscal rules and medium term budget planning – step by step recommendations”

Component 2

Activity 2.1



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This is a summary of the assessment report that has been produced as a result from activity 2.1 "Assessment of current budget process, practices and capacities for fiscal rules and medium term budget planning – step by step recommendations" within the Twinning Project "Strengthening the medium term budgeting for effective public financial management".

The overall objective of the Twinning Project is to ensure and maintain sustainable and sound public finances by improving public finance management. The activities of the Project are aimed at improving the effectiveness of medium-term budget planning, program budgeting and budget classification, as well as fiscal reporting in line with ESA standards. The Project was launched Dec 2015 and it will end Nov 2017 and the main beneficiary is the Ministry of Finance (MoF), Department of Budget and Funds.

Activity 2.1 is part of Component 2 which aims to improve the medium term budgeting in Macedonian Ministry of Finance. The recommendations produced with this report are given to the main beneficiary of the Project, Ministry of Finance.

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It should be pointed out that this assessment is based on limited studies of the Macedonian budget practices, legislation and processes, through expert missions done. It should therefore be regarded mainly as a base for further discussion.

## 1. Introduction to fiscal rules and medium term budget framework

Fiscal rules are institutional settings under which fiscal variables are allowed to develop sustainably in the medium to long run (IMF 2015). Some 80% of fiscal rules in the world are set for public debt or budget balance, however also expenditure rules are typical. One idea for setting expenditure rules is to cut the connection between revenue and expenditure development in order to avoid pro-cyclical fiscal policy and to reduce the risk to use one-off revenues or increasing tax revenues of booming economic cycle to increase permanent expenditure.

Effective public finance management requires medium term planning because most discretionary fiscal policy decisions have economic and budgetary implications beyond the implementation year. Expenditure rules have been noticed to be effective in medium term planning while they target that part of the budget where the Government has the most direct control. Successful rules need to be simple to communicate and to monitor, and need to have strong institutional arrangements behind them.

Fiscal rules and medium term budget frameworks (MTBF) have been associated with stronger fiscal performance that supports budget discipline and macroeconomic stabilization. However, international experience also shows that rules can't substitute strong commitment to fiscal discipline (IMF 2015). The need for political commitment can't be emphasized too much – that is the key issue.

In Council Directive 2011/85/EU (Budgetary Frameworks Directive) MTBF is defined as “a specific set of national budgetary procedures that extend the horizon for fiscal policy making beyond the annual budgetary calendar, including the setting of policy priorities and of medium term budgetary objectives”. Sometimes medium term expenditure framework (MTEF) is used almost as synonym for medium term budget framework (MTBF). In our Twinning Project, we refer to MTBF when we mean the set of multiannual budgetary rules and procedures and the whole Fiscal Strategy document, which also expresses commitment and linkage to fiscal deficit and debt rules. By MTEF we refer to the multiannual expenditure planning and the expenditure ceilings set for expenditure development.

## 2. Practices for fiscal rules and medium term budget planning - recommendations

### 2.1 Framework and legislation for fiscal rules

There are various issues to consider in planning fiscal rules framework and institutions supporting it in public finance management. Key issue is to keep it simple and easy to communicate to the public.

The success of numerical fiscal rules (such as deficit to GDP ratio, debt to GDP ratio, expenditure ceiling) depend on institutional settings, such as strong legal basis, top-down process, data availability, enforcement mechanisms and independent monitoring (IMF 2015).

Recommendations:

While planning fiscal and budget framework, premium should be placed on simplicity of rules and fiscal targets. Fiscal targets should be expressed in nominal terms.

Under EU fiscal framework deficit and debt rules apply for general government (ESA2010). However, national rules can also be set e.g. for the central government and by budget definitions, but it is necessary to also monitor and report on the overall public sector.

MK could adopt a combination of numerical and procedural approach to fiscal rules. This means that there could be maximum guiding numerical limits, such as 3% for deficit and 60% for debt-ratios, e.g. in the Constitution. However, in addition the legislation should include a more operational procedural approach that requires the Government to adopt own numerical fiscal targets with mechanisms that safeguard that the limits described in the Constitution can't be exceeded.

The procedural approach of legislation should include following elements: i) principles for fiscal policymaking; ii) requirement that the Government shall submit a Statement of Fiscal Policy to the Parliament following the election (incl. numerical fiscal targets for parliamentary term); iii) annual obligation for the Government to submit the Fiscal Strategy to the Parliament for adoption.

Also automatic procedural correction mechanism is recommended. This could be a legal requirement for the Government to follow the difference between the realized deficit and planned deficit seen from the Final Account. If the realized deficit is higher than planned, it needs to be explained why this happened and also, how re-balancing equal to this amount will be implemented within the supplementary budget of the ongoing year and within the Budget for the next year.

In addition, the main procedures and rules for medium term expenditure framework (MTEF) should be described in the legislation.

It is not recommended to adopt new laws; but rather to introduce changes in the existing Budget Law concerning the procedural framework for fiscal rules and expenditures.

## 2.2 Reliable macroeconomic forecast as a starting point

Government's multiyear projections of revenue and expenditure are only as credible as the economic and demographic assumptions on which they are based. Just about every revenue and expenditure item in the budget is driven by some exogenous factor. The precision of the MTBF can be only as high as the forecasting accuracy of these economic and non-economic determinants.

A central factor is the use of a comprehensive macroeconomic forecasting model that ensures that inflation, exchange rates, consumption, unemployment, and the output gap are consistent with one another.

### Recommendations:

The new macroeconomic model of the MoF should be tested, re-assessed and put in use. Next, the model should be used to support economic policy planning, by making projections for the baseline macroeconomic scenario and / or alternative scenarios in the upcoming period.

In addition to improving the forecasting model itself, it is also recommended to establish a specific timetable of the macroeconomic forecast, which would be closely linked to the preparation process of the Fiscal Strategy and the Budget. In order to improve medium term revenue and expenditure baseline scenarios, the MoF should submit timely the needed forecast data to all relevant institutions for internal use.

Same recommendation applies to Budget process. The Budget Law should be amended to include provisions on macroeconomic projections.

It is recommended to highlight in national legislation, which institution / MoF department is responsible for making the macroeconomic forecast and what are the principles for forecasting.

### 2.3 Process and timetable for (medium term) budgeting

Fiscal policy making needs well defined process, timetable, procedures and structures, so that it is clear for all stakeholders what should happen and when. This sets efficient framework also for the political decision making. In order to create credibility, and also transparency, into fiscal policy, it is crucial to keep the timetables set and publish the official documents.

#### Recommendations:

Multiannual strategic budget planning should be done during winter-spring when preparing the Fiscal Strategy as a real medium term budget framework (MTBF) document including expenditure ceilings (MTEF).

When setting the Fiscal Strategy timetable, many issues need to be considered (e.g. timetable of macroeconomic forecast; enough time for baseline scenario; enough time for the Government for decision making and prioritization of the new initiatives). Especially during the first years of reform it is recommended that timetable is not too tight. When different stakeholders get more familiar with the process and their obligations in it, the process timeframe could be shortened up.

Below is draft suggestion for one possible Fiscal Strategy timetable and process:

- Start of the year: MoF (Budget and Funds Department) sets up baseline scenario per budget user for the upcoming 3 years; MoF sends Fiscal Strategy Circular Letter with the baseline scenario to the budget users.
- Each budget user reviews their baseline scenario and drafts proposals for new initiatives for financing (policies, projects and activities); Negotiations take place between MoF and budget users.
- During March: Macroeconomic Policy Department of the MoF prepares macroeconomic projections, which MoF submits to all relevant institutions; Based on new macroeconomic forecast and other data, the revenue projections for 3 years are prepared; After that fiscal space is assessed for new initiatives for financing or cutting baseline scenario. In addition, Budget and

Funds Department makes systematization of budget user new initiatives in a format that initiatives can be submitted to the Government.

- During April: MoF submits to the Government the total baseline scenario and a list of new initiatives for financing; The Government has discussion and makes prioritization of the new initiatives.
- Government adopts the Fiscal Strategy with a total binding limit for the first year and indicative for the second and the third year. Fiscal Strategy includes an annex containing the limits per budget user. Fiscal Strategy is sent to the Parliament for adoption.

After that Budget process would begin with MoF Circular Letter. Also Budget process could be moved to start earlier during the summer and to end earlier in autumn.

The revenue estimation process for baseline scenario should also be improved. The process should a) have clear organizational structure with coordination and ownership of MoF b) be better based on common macroeconomic projections c) be made in cooperation between different departments, ministries and institutions.

#### 2.4 Organizational structure in MTBF and Program Budget reform

One main idea behind the expenditure frameworks, and also program budget reforms, is to support efficient budget planning and resource allocation to meet the priority expenditure needs discovered.

In many countries the binding expenditure ceiling is divided into “sub-ceilings”. The sub-ceiling levels are set in the medium term budgets creating constraint for the Budget planning. This forces the line ministries and agencies/institutions to negotiate the more detailed allocation of finances in the Budget. As support and background for the negotiations performance contracts and indicators can be used.

##### Recommendations:

It would be good to have the line ministries steering the budget planning in their sectors, as recommended e.g. by SIGMA (2015). However, in the first phase of reform this might not be possible.

At the first phase key MTEF classification could be organizational approach. Although MTEF would be binding only at the level of total expenditures, each budget user should have its own ceiling (could be presented as annex to Fiscal Strategy).

Indicative ceilings could be published in Fiscal Strategy also for new program budget policy areas (as soon as that reform has taken place) in order to get more familiar with program budgeting approach.

The coding of the budget users should be revised to better support the new policy area (and program) classification with medium term approach.

## 2.5 Assessment of baseline scenario and fiscal space

Reliable medium term baseline scenario is of key importance in medium term (and also Budget) fiscal policy making. However, also reliable evaluation of new initiatives for financing and their fiscal effects is important.

Baseline scenario means estimation of expenditures and revenues with no discretionary changes, no new initiatives for financing. In other words, with “business-as-usual” of existing legislation.

Fiscal space means the room for maneuver between the budget balance and debt based on baseline scenario of revenues and expenditures, and what is the limitation for balance and debt according to the fiscal targets set.

### Recommendations:

Key issue is to develop reliable medium term baseline scenario. This process could start with MoF work where draft baseline scenario would be developed in the beginning of the year according to MoF knowledge of compulsory needs and realistic development taken into account previous year realization.

Budget analysts from the Budget and Funds Department possess knowledge which should be used systematically in the process of preparation of the Fiscal Strategy. This knowledge should be used as support to MoF decision making (e.g. to assess the baseline scenario, to assess if budget user proposals are realistic, to ask clarifications, to analyse levels of self-financing revenues...)

After MoF baseline scenario per budget user is drafted and sent to each budget user, the budget users would check their medium term baseline and suggest corrections, and in addition send data concerning the new initiatives for financing.

The nature of MoF data requests and templates should be totally reformed – both for Fiscal Strategy preparation and for Budget preparation. It could be recommended that same kind of templates would be used in both processes i.e. Fiscal Strategy would also be built “bottom up” imitating the Budget data (incl. economic, program, revenue source classification). The fiscal data would be presented together with explanation on the change needed compared to the previous medium-term projections (starting point for Fiscal Strategy would be the previous Budget and for the Budget it would be the previous Fiscal Strategy). However, at the beginning of the reform the baseline projections will be prepared without giving comparison and explanation in relation to previous projections hence there are none.

It is recommended to divide the needed and proposed changes into two categories: 1) compulsory / non-discretionary (baseline) 2) discretionary / new requests (new initiatives for financing). New data templates need to be developed for the Fiscal Strategy data to meet this need.

The data templates should be harmonized with e-Budget application (with some modifications to the system) in order not to have huge amounts of manual work.

## 2.6 Expenditure ceilings for medium term (MTEF)

Expenditure rules set limits on total, primary or current spending, and they are usually set in absolute terms or growth rates with time horizon of 3-5 years. These rules are not typically directly linked to debt sustainability objectives since they do not constrain the revenue side (IMF 2015). There is various terminology for expenditure rules – such as expenditure ceiling, expenditure framework, spending limits and medium term expenditure framework (MTEF). However, the idea behind is basically the same – to set restriction for the public spending for medium term without linkage to revenue levels.

### Recommendations:

Medium term expenditure framework (MTEF), i.e. expenditure ceilings, should be defined through assessment of fiscal space taking into consideration the fiscal targets (deficit, debt). They should be binding for the first year, and restrict also the Government itself.

Pure top-down calculation from deficit target is not enough in setting the ceiling – it also needs to be secured that bottom up baseline scenarios meet the ceilings and are realistic. Policies need to be in line with the expenditure levels set.

The expenditure ceiling should be indicated by budget users – however, for the Government the total expenditure ceiling should be strictly binding, leaving space for necessary reallocations.

### 2.6.1 Indicative vs. binding nature of MTEF and length of planning horizon

According to Budget Framework Directive EU member states must establish credible, effective medium term budgetary framework providing for the adoption of a fiscal planning horizon of at least 3 years. It does not state that all three years should be fully binding, but the framework needs to support achievement of numerical fiscal rules.

Accountability and commitment of the Government can be stronger in MTEF framework where fiscal policy objectives and rules are clearly formulated for the government term – so for four years. However, many countries have 3-year planning system. What is important is to establish strong track record for the system early to build credibility. If a rolling 3-year planning horizon creates this more easily, then for sure it is better option than 4-year planning for the whole government term.

### Recommendations:

As starting point the medium term expenditure ceilings and their total level should be binding only for the first year and indicative for the latter years.

However, also the indicative years and changes made to them need to be in line with the fiscal targets. Changes can take place for the indicative years, but their origin in comparison to previous medium term budget planning should be explained. There could also be limitation, how much indicative ceilings can be changed from previous year Fiscal Strategy. Revisions downwards should be possible, but revisions upwards could be restricted.



One option could be to link the difference between the tax revenue forecast and outturn of previous year. If the revenue outturn from year t-1 has been higher than budgeted/forecasted, e.g. 50% of this amount could be used to raise the expenditure levels of years t+1/t+2/t+3 (i.e. the Fiscal Strategy planning years).

After some years even more binding ceilings could be introduced to replace the indicative years. Before this it is important to establish strong track record and build credibility of the system.

While Macedonians have years of experience from 3-year rolling planning, medium term planning with 3-year-model is a good starting point. Later in the next phase a more advanced 4-year approach for the whole government term could be implemented.

#### 2.6.2 Coverage of MTEF and exclusion of some items

It is good to consider what MTEF should cover or not and why. When the objective is to reduce government expenditure and cut spending in order to be able to keep low taxes and modest or declining debt level, the focus should be in total expenditure and not some part of it.

Another point of view to look at the question of coverage of MTEF is to evaluate, how much power of decision the Government has over the issue. In some countries expenditures that the Government can't directly control (no direct decision making power) have been left outside the scope of the MTEF ceiling.

#### Recommendations:

MTEF rules should be transparent and simple, and this goes often hand in hand with comprehensive framework.

In MK it is recommended that the MTEF should cover the core budget and the funds of the central government and expenditures financed through earmarked loans.

- Local government expenditure could be excluded, however, transfers to local governments should be part of MTEF;
- Donations could be excluded, because there is no reason to restrict the expenditure financed through donations;
- Expenditures linked to self-financing revenues could be excluded – however, it needs to be more closely reviewed what should be included in self-financing revenues.

It seems that the cyclical expenditures do not play key role and cause major annual changes. This indicates that also cyclical expenditure should be included in MTEF. Also debt interest expenditure should be included in MTEF.

### 2.6.3 Elements of flexibility and price level adjustment in MTEF

When designing a multiannual expenditure rule, also elements of flexibility and price level adjustment need to be considered. Flexibility can be created by different means. Most typical way is to include unallocated margin inside the ceiling. By this we mean certain amount of budget expenditure that can be used for unforeseen expenditure. This margin is a slump sum which is not allocated for the budget users yet. However, in deficit and baseline calculation this amount of money will be taken into consideration.

Unforeseen compulsory expenditure can be e.g. increased unemployment benefits due to recession, increased debt interest costs, or sudden need to cover costs of unexpected events / disasters.

Ceiling can be set in real terms or in nominal terms. In the latter case the ceiling is fixed for the whole planning period and it already includes an annual adjustment equal to the predicted cost trends.

#### Recommendations:

It is recommended to have “technical margin” for MTEF and budgeting. Technical margin is a buffer meant for financing compulsory fluctuation in expenditure (such as cyclical changes, interest rate changes, other changes deriving from macroeconomic changes or external shocks such as natural disasters). This unallocated technical margin should be part of in the calculations for total expenditure limits. It must be well-defined in legislation where technical margin can be used.

In the future when the limits for medium term would be made binding (fixed) it would be necessary that the technical margin is set on higher level, while at the same time the use of the margin should be legally regulated.

It seems that at the moment there are no major reasons to have carry over rules in MK.

In MK only few expenditure items are statutory indexed. Taking this into account, inflation would probably not create much pressure on the expenditure ceiling, especially if only the first year would be binding. Therefore it is recommended to establish simple nominal medium term expenditure framework and use technical margin in case there is some surprising price level increase.

### 2.7 Accessibility and contents of budget data

Budget documents show, how Government prioritize and achieve its annual and multi-annual objectives, and how resources are raised and allocated for the delivery of public services. Such documents must be clear, transparent, credible and easily accessible – the presentation of data need to be understandable for the citizens.

#### Recommendations:

Fiscal Strategy document should be further developed – contents should be summarized into informative and accessible tables and graphs. Also deviations compared to previous projections should be explained (e.g. new initiatives for financing).

In order to highlight reliable macroeconomic forecast, it is recommended that macroeconomic projections are presented in Fiscal Strategy as its own chapter. Also local government issues could be gathered as own separate chapter.

It would also be valuable to recognize and report fiscal and macroeconomic risks in Fiscal Strategy (sensitivity analysis of macro-fiscal risks, information on other risks, information on contingent liabilities).

Also the Budget should be developed to meet the needs of medium term planning and program budget reform (more discussion about this is in Project Component 1).

In addition the Final Account could be improved. It could give more detail explanation on the main deviations from the budgeted and how this affects the deficit and debt targets and explain what will be the corrective measures that the Government will take.

For promoting transparency of the overall budget documentation further improvements in certain parts are needed.

## 2.8 Independent monitoring and evaluation of fiscal policy

There is growing interest for the role of independent fiscal institutions, such as Fiscal Councils, in helping to improve fiscal performance through independent monitoring and evaluation.

Independent bodies can be established in many ways e.g. to take care of tasks of monitor the compliance with numerical fiscal rules and quality of forecasting.

### Recommendations:

Reliable and independent (or independently audited) macroeconomic forecast and independent monitoring of compliance with fiscal targets are important to safeguard the credibility of medium term budget framework. It is more long term issue for MK to assess which institute could be given the mandate for fiscal policy auditing.

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